SHAREHOLDER VOTING ON ALL STOCK OPTION PLANS: AN UNNECESSARY AND UNWISE PROPOSITION

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In 2001, it was revealed that Enron and other American corporate giants had engaged in misleading and corrupt practices. The result was that investors lost hundreds of billions of dollars, and more importantly, their faith in corporate governance and the stock markets. As a result of this crisis, Congress, the SEC, and the major stock exchanges proposed new securities laws and regulations. There were numerous proposals to "clean up" corporations, but few have been approved and implemented. One change that has been adopted requires member corporations of the major stock exchanges to obtain the approval of shareholders for all stock option plans. This marks a significant shift in corporate governance and was deemed necessary by the major exchanges because executives who possessed sizable quantities of stock options played a large part in the scandals that rocked corporate America.

This Comment addresses the modified rule for stock option plans and asks whether it will have a significant effect on corporate governance. The Comment begins by analyzing the history of stock options and the laws and regulations for shareholder voting on stock option plans that existed prior to the new rule. It ultimately concludes that the new rule will do little to prevent future abuses associated with stock options, but will cause a dramatic shift in corporate power from the board of directors to shareholders.

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INTRODUCTION

The incredible stock market rise in the 1990s gave way in the late 1990s and early 2000s to a bear market and dramatic decreases in stock prices that had severe effects on the American economy. One of the main causes of this market decline was the corrupt practices of a few corporations, combined with a lack of investor confidence in corporate governance.[1] What followed was six of the eight largest bankruptcy filings in U.S. history (based on total pre-bankruptcy assets) occurred in less than twelve months after Enron filed for bankruptcy protection in December 2001.[2] In four of these bankruptcies, it was revealed that the executives running the corporations had engaged in questionable practices to facilitate risky (and often fraudulent) transactions.[3] As a result, there was a public outcry by investors

1. *See, e.g.*, *NYSE Approves New Governance Rules*, L.A. TIMES, Aug. 2, 2002, at C4 ("[C]orporate accounting and ethical scandals at companies such as Global Crossing Ltd. and Enron Corp. demoralized investors and sent stocks sliding."); *see also* Lisa Singhania, *Taking Stock*, ST. LOUIS POST DISPATCH, July 14, 2002, at E1, *available at* 2002 WL 2573492 (commenting that Richard Grasso, former chairman and CEO of the New York Stock Exchange, saw his responsibilities expand during 2001 and 2002 to include the restoration of investor confidence in American companies as a result of accounting scandals).

2. *See* BankruptcyData.com, *The Largest Bankruptcies 1980–Present*, *at* http://bankruptcydata/Research/15_Largest.htm. The eight largest bankruptcy filings in history, with pre-bankruptcy assets (rounded to the nearest billion) and date of filing, are: WorldCom, Inc. ($104 billion, July 2002); Enron Corp. ($63 billion, December 2001); Conseco, Inc. ($61 billion, December 2002); Texaco, Inc. ($36 billion, April 1987); Financial Corp. of America ($34 billion, September 1988); Global Crossing Ltd. ($30 billion, January 2002); UAL Corp. ($25 billion, December 2002); Adelphia Communications ($21 billion, June 2002). *Id.*

3. *See, e.g.*, William B. Harrison, Jr., *Banks Were Victims in Fraud Cases, Not Accomplices*, WALL ST. J., Sept. 18, 2002, at A18 (stating that WorldCom failed because "executives fraudulently capitalized normal operating expenses"; Adelphia collapsed because executives "fraudulently diverted assets for personal use"; and Enron folded because executives "created a series of transactions through partnerships that enriched certain individuals and concealed losses"); *see also* Yochi J. Dreazen & Dennis K. Berman, *Leading the News: Winnick Knew of Swap Deals at Global Crossing*, WALL ST. J., Oct. 1, 2002, at A3 (explaining that Gary Winnick, the chairman of Global Crossing at the time of its questionable transactions, knew about the swap

to tighten corporate governance in America in order to prevent the types of scandals and abuses that caused these bankruptcies.[4] At the forefront of these scandals were corporate executives. One of the major factors that led executives to engage in risky transactions was the potential for large personal gain as a result of their personal stock option holdings. As one commentator explained, "the revelations of corporate misdeeds at Enron, Global Crossing, and WorldCom confirm[ed] that there is an urgent need to rein in greedy and overmighty chief executives, and to curb rampant abuses of stock options."[5]

The result of this crisis in the stock markets was that Congress, the SEC, and the major American stock exchanges (the New York Stock Exchange, NASDAQ, and AMEX) proposed new securities laws and regulations. This Comment addresses the change by each of the major exchanges to require shareholder approval of *all* stock option plans.[6] This change was approved by the SEC in the Summer of 2003. Under the new rules, a corporation must gain shareholder approval for all equity compensation plans, with a few minor exceptions, in order to meet the listing requirements of the major stock exchanges.[7] This change creates the

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transactions and even volunteered his personal influence to close the deals that ultimately lead to the downfall of the company).

4. *See, e.g.*, Janet Whitman, *Stock Options Face Scrutiny in Wake of Enron*, WALL ST. J., Apr. 3, 2002, at B7B (commenting that the collapse of Enron created a public outcry for greater accountability of corporate boards of directors and executives).

5. *WorldCom: Accounting for Change*, ECONOMIST (London), June 29, 2002, at 13, *available at* 2002 WL 7246630.

6. The complete text of the change by the New York Stock Exchange reads: "To increase shareholder control over equity-compensation plans, shareholders must be given the opportunity to vote on all equity-compensation plans, except inducement options, plans relating to mergers or acquisitions, and tax qualified and excess benefit plans." NEW YORK STOCK EXCHANGE, CORPORATE GOVERNANCE RULE PROPOSALS REFLECTING RECOMMENDATIONS FROM THE NYSE CORPORATE ACCOUNTABILITY AND LISTING STANDARDS COMMITTEE AS APPROVED BY THE NYSE BOARD OF DIRECTORS AUGUST 1, 2002, at 13 (submitted to the SEC on Aug. 16, 2002), *available at* http://www.nyse.com/pdfs/corp_gov_pro_b.pdf [hereinafter NYSE GOVERNANCE RULE PROPOSALS]. The changes to shareholder approval of stock option plans by the NASDAQ and AMEX are very similar in wording and achieve the same result because the SEC "was adamant that the . . . markets have consistent rules." Deborah Solomon, *SEC to Approve Governance Rules by NYSE, Nasdaq*, WALL ST. J., Oct. 13, 2003, at C5; *see also* Judith Burns, *Everything You Wanted to Know About Corporate Governance . . . But Didn't Know to Ask*, WALL ST. J., Oct. 27, 2003, at R6 (commenting on the roles of the stock exchanges in corporate governance and that the change mandating that shareholders vote on all option plans was approved by the SEC in the Summer of 2003).

7. In addition to the requirement that shareholders approve all equity-based compensation plans, there are four other categories of modified rules: (1) Enlarging the role and power of independent members of listed companies' boards of directors; (2) Requiring listed companies to adopt codes of business conduct and corporate governance guidelines; (3) Requiring the CEOs of listed companies to certify annually that their company is complying with NYSE listing standards

perception that shareholders will be in control to prevent abuse, but in reality, it infringes on the ability of management to run companies and will do little to prevent future abuse by executives.

In this Comment, I analyze the modified rules for shareholder approval of stock option plans by first examining the history of stock options and whether corporations should use them. Next, I examine the laws and regulations that existed under state law, SEC regulations, stock exchange rules and the Internal Revenue Code prior to this recent change to determine when shareholders would vote on stock option plans if the latest change by the exchanges had not been approved. I then consider whether the change by the major exchanges to have shareholders vote on all option plans is a wise allocation of power to shareholders, whether shareholders should be making ordinary business decisions, and whether voting on all option plans will reduce the potential for abuse by corporate executives. Finally, I conclude with recommendations for more effective means to prevent the abuse of stock options.

I. STOCK OPTION HISTORY

The use of stock options as a form of compensation has increased dramatically since the 1980s.[8] They are prevalent in the compensation of all employees, especially executives. According to a survey by Frederick W. Cook & Co., 99 percent of the nation's 250 largest companies compensate their executives with stock options.[9] In 1992, stock options accounted for only 27 percent of CEO compensation, but by 2002 they accounted for 60 percent.[10] The median gain on stock options exercised by the CEOs of

and that information provided to investors is accurate; (4) Encouraging the SEC and other regulatory bodies to address accounting, auditing, and disclosure standards. Stephen M. Bainbridge, *A Critique of the NYSE's Director Independence Listing Standards*, 30 SEC. REG. L.J. 370, 374–75 (2002) (footnotes omitted).

8. *See* Neil H. Aronson, *Preventing Future Enrons: Implementing the Sarbanes-Oxley Act of 2002*, 8 STAN. J.L. BUS. & FIN. 127, 130 ("During the last twenty years, the CEO became a hero in American society . . . by raising the value of company stock and expanding the use of stock option grants.").

9. *See* FREDERICK W. COOK & CO., INC., LONG-TERM AND STOCK-BASED GRANT PRACTICES FOR EXECUTIVES AND DIRECTORS 5 (2002), *available at* http://www.fwcook.com/top250-2002.html.

10. *See* Tim McElligott & Toby Weber, *Drum Beat of Reform Grows Louder*, TELEPHONY, Sept. 23, 2002, at 8, 8–9 (reporting statistics as found by the Conference Board Commission on Public Trust and Private Enterprise and the opinions of compensation experts that the prevalence of stock options entices CEOs to manage businesses for short-term stock gains without concern for the long-term future of the company). It is interesting to note that despite the nearly universal outcry against excessive compensation for executives of large corporations, no corporate

roughly 150 large U.S. companies during 2000 was $1,892,938, but this amount was significantly lower than the median gain of $2,857,676 in 1999.[11] Not only are stock options valuable compensation tools for executives, they are important compensation techniques for board members, as exemplified by a 2000 Korn/Ferry International study which found that 64 percent of all companies use stock options as a means to compensate board members.[12] Stock options were once primarily used for management personnel, but the technology boom of the 1990s increased their use because they were instrumental in attracting employees to risky business ventures and were also an unusually effective method of financing new business ventures.[13]

A. Why Use Options

One of the main reasons for using stock options is to align the incentives of executives with the interests of shareholders.[14] A problem that exists in corporations is that the managers and executives make business decisions with their jobs at stake, and decisions that lead to negative consequences will likely harm their future earnings with the company. As a result, executives and managers are risk averse because they have little to gain if the company does well, but much to lose if the company does poorly.[15] In contrast, shareholders are not as risk averse as executives and

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executives had lost their jobs because of excessive compensation until September 2003 when in a touch of irony, the head of the New York Stock Exchange, Richard Grasso, was forced to resign because of his compensation package. *See* Tom Petruno & Kathy M. Kristof, *Final Bell for Grasso Strikes a Nerve; The Stock Market Chief's Ouster May Embolden Activist Investors to Increase Pressure on Company Boards to Pare Compensation*, L.A. TIMES, Sept. 21, 2003, at A1 ("But until last week, no company chief had lost his job solely because he was earning 'too much.'").

11. *The Boss's Pay*, WALL ST. J., Apr. 12, 2001, at R11 (reporting the results of a study by William M. Mercer, Inc. of roughly 150 CEOs of large U.S. companies).

12. KORN/FERRY INTERNATIONAL, 27TH ANNUAL BOARD OF DIRECTORS STUDY 2000, at 14 (2000), *available at* http://www.kornferry.com.br/upload/informacao/artigos/KF27thANNUAL.PDF.

13. *See, e.g.*, Anthony J. Caputo & Julia Caputo Stift, *An Equity Compensation Plan Giving Employees Stock Options Must Comply With a Host of Securities and Tax Laws for the Company and Recipients to Get the Biggest Payoff*, 80 MICH. B.J. 31, 35 (2001) (explaining that stock options are an old compensation technique, but that developments in the economy have "popularized the mass use of stock options").

14. *See* Randall S. Thomas & Kenneth J. Martin, *The Determinants of Shareholder Voting on Stock Option Plans*, 35 WAKE FOREST L. REV. 31, 38 (2000) ("[S]tock options help align managers' interests with those of shareholders. Stock-based pay, therefore, is claimed to be superior to more fixed components of compensation, such as salary and bonuses, because it rewards managers for thinking like shareholders." (citation omitted)).

15. For corporations, this cost of management acting in a way that differs from the interests of shareholders is known as shirking, which is one form of agency costs. *See, e.g.*, STEPHEN M.

managers because they have diversified portfolios, and therefore have less downside from risky, but high-return investments.[16] Stock options are therefore useful to align the incentives of executives and managers with those of shareholders because options provide company management with an incentive to undertake riskier projects that normally have higher returns for investors.[17]

Another reason frequently stated for granting stock options is to attract and retain employees. Stock options are useful as an employee recruitment technique at new companies because they allow employees to participate in the upside of a company with minimal cost to the company. For example, if a person is highly paid at an established company, they will be reluctant to forgo the certainty of their salary for the uncertainty of a new business venture. Even if the salary is the same at each company, the rational person will opt for the stability of the mature company. Often, however, the new company is not in a position to pay a comparable salary because of the high costs associated with starting a business. The solution, therefore, is for a new company to grant stock options to the new employee as an inducement to join the business venture. The employee will then share in the potential upside of the company, and a partnership between the employee and company will form so that the employee will develop a greater concern for the company's future.[18]

BAINBRIDGE, CORPORATION LAW AND ECONOMICS § 1.5, at 35–38 (2002). Agency costs are an inevitable part of the modern corporation because authority and discretion do not lie with the owners, but with the agents. It has been noted that in order to remove agency costs from corporations, the agent would have to possess less discretion, yet this step has not been taken because agents with some measure of discretion are a necessary component of a corporation. *Id.* As a result:

> Several mechanisms have evolved to mitigate potential agency problems. First, compensation plans tie the income of managers to the success of the firm. A major part of the total compensation of top executives is typically in the form of stock options, which means that the managers will not do well unless the shareholders also do well.

ZVI BODIE ET AL., INVESTMENTS 6 (5th ed. 2002).

16. *See, e.g.*, Thomas & Martin, *supra* note 14, at 37–40 (explaining the divergent interests of shareholders and management and that stock options are a valuable tool used to align these interests).

17. *Id.*; *see also* Brian J. Hall & Jeffrey B. Liebman, *Are CEOs Really Paid Like Bureaucrats?*, 113 Q.J. ECON. 653, 656 (1998) (explaining that CEOs have goals conflicting with shareholders and that the use of stock and stock options is the most direct solution to align their interests with those of shareholders).

18. *See, e.g.*, Mark A. Clawson & Thomas C. Klein, *Indexed Stock Options: A Proposal for Compensation Commensurate With Performance*, 3 STAN. J.L. BUS. & FIN. 31, 40 (1997) (explaining that for many firms in Silicon Valley during the 1990s, stock options were generally the only "currency" that they could afford as a form of employee compensation).

Not only do stock options attract employees, they are also useful in retaining them. There are very few statutory requirements governing the structure of stock options.[19] Most corporations, however, impose requirements that the employee must remain with the company for a certain number of years, or that the options cannot be transferred for a certain amount of time after exercise.[20] Many commentators have called stock options "golden handcuffs" because of the requirements and incentives for employees to remain with a company.[21]

One additional benefit that encourages companies to utilize stock options as a form of compensation relates to accounting rules.[22] For accounting purposes, there is no requirement to expense stock options directly on the income statement. Under Statement of Financial Accounting Standards (SFAS) 123, adopted by the Financial Accounting Standards Board (FASB) in October 1995, companies have the choice of accounting for options on the income statement using either the fair market or intrinsic value method. If a company chooses the intrinsic value method, SFAS 123 provides that it must also make a pro forma disclosure —usually in a footnote—using the fair value method of accounting.[23] Needless to say, nearly every company granting stock options has chosen to use pro forma disclosures rather than incur a direct expense for the value of the stock options on its income statements, although treating stock

19. The most notable regulations of stock options are contained in the Internal Revenue Code and pertain to incentive stock options (ISOs). Following these regulations can result in favorable tax treatment, but a corporation can choose to issue stock options that do not meet the ISO requirements, yet still comply with state, SEC, and stock exchange regulations. See *infra* notes 25–30 and accompanying text for a discussion of ISOs.

20. *See, e.g.*, Michael W. Melton, *The Alchemy of Incentive Stock Options—Turning Employee Income Into Gold*, 68 CORNELL L. REV. 488, 489–90 (1983) (analyzing model stock option plans that normally include the following: nontransferability of the option, a fixed price and time period for the option to be exercised, termination of the option privilege if the employee ceases employment, restrictions on transferability of the stock after it is received, and possible forfeiture of gain realized at exercise if the employee terminates employment within a specified period after exercise).

21. *See, e.g.*, Caputo & Stift, *supra* note 13, at 35 (stating that tying an employee's financial interests to the success of the employer is a form of "golden handcuffs"); Whitman, *supra* note 4 ("Perhaps more important than the millions of dollars saved by infant companies and their venture-capital backers, stock options serve as a golden handcuff, linking employees' fortunes to the success of the business.").

22. *See* Susan J. Stabile, *Motivating Executives: Does Performance-Based Compensation Positively Affect Managerial Performance*, 2 U. PA. J. LAB. & EMP. L. 227, 276 (1999) ("Stock options are the only type of compensation that generate an expense that is deductible for tax purposes but that does not have to be expenses for financial accounting purposes.").

23. *See* FINANCIAL ACCOUNTING STANDARDS BOARD, SUMMARY OF STATEMENT NO. 123, ACCOUNTING FOR STOCK-BASED COMPENSATION (1995), *at* http://www.fasb.org/st/summary/stsum123.shtml.

options as an expense is becoming an increasingly popular means of corporate governance.[24]

Stock options not only offer favorable financial statement accounting, but they also result in positive treatment for tax purposes. Under the Internal Revenue Code, there are two types of stock options: incentive stock options (ISOs) and nonqualified stock options.[25] ISOs are limited to $100,000 per individual, are not tax deductible to the issuing company, and are taxable to the employee only when the underlying stock is sold (although there may be Alternative Minimum Tax issues upon exercise). Most importantly, options are considered ISOs only if the employee remains with the employer for a specified time. In contrast, nonqualified stock options are generally taxable to the employee and deductible to the employer upon exercise.[26] The distinction allowing some options to be tax-deductible expenses becomes important when considered in conjunction with section 162(m)(1) of the Internal Revenue Code. This section denies publicly held corporations deductions for compensation over $1 million to the CEO and the four highest compensated officers as disclosed under the Securities Exchange Act of 1934 (the '34 Act).[27] Another part of section 162, however, provides an exception for compensation that is payable as a result of achieving performance goals, and subsequent Treasury Regulations have found that stock options fall under this exception.[28] The result of this exception is that a company can grant highly paid executives nonqualified stock options and treat the options as a tax deductible expense because stock option grants of over $100,000 to the same person in the same year lose their ISO status. One caveat that companies must remember is that for an option plan to be tax deductible, it must qualify as a performance-based plan, and in order to attain this status, shareholders must

24. The trend of using pro forma disclosures has started to change. More companies are beginning to expense stock options. By September 16, 2002, eighty-one corporations had announced that they would expense options, but these were mostly older companies such as Coca-Cola and Pfizer that do not rely as heavily on options. *See* Jerry Useem, *In Corporate America It's Cleanup Time*, FORTUNE, Sept. 16, 2002, at 62, 64. However, many corporations, especially technology corporations, oppose expensing stock options and intend to continue pro forma disclosures. *Id.* at 66.

25. *See* I.R.C. §§ 83, 422 (2000).

26. *See* I.R.C. § 83. Nonqualified options usually have conditions that make the options nontransferable or subject to forfeiture and are thus taxable when these restrictions lapse or the option is exercised. WILLIAM A. KLEIN ET AL., FEDERAL INCOME TAXATION 286, 287 (2003). In contrast, there are certain instances when the taxable event occurs at issuance instead of upon exercise of the stock option, such as situations where the stock options are not restricted or subject to forfeiture. *Id.* at 288–89.

27. *See* I.R.C. § 162.

28. *See* Prop. Treas. Reg. § 162.27 (1998).

approve the plan.[29] As a result, companies are able to take huge tax deductions through the issuance and exercise of options.[30] For many companies, paying an amount equivalent to the stock options in the form of cash compensation would not yield a deductible expense for tax purposes.

B. Why Not Use Options

Despite the advantages associated with stock options, there are also some drawbacks. Two of the major concerns are that stock options create perverse incentives and that they dilute existing shareholders' ownership.

The risk of fraudulent activity from stock options is most readily seen in the disasters that ensued from the large ownership stakes that the CEOs and other executives had in Enron, Global Crossing, WorldCom, and Adelphia.[31] Because they owned a substantial number of shares, executives were focused on short-term business strategies that would drive up the price of the stock: "Studies indicate that CEOs may cut back on research and development and advertising expenditures, pursue risky new ventures, or use corporate funds and borrowing capacity to buy back stock and reduce shares outstanding in order to increase the market price of the stock and reap additional compensation."[32] This excess risk-taking by executives whose fortunes are tied to the success of the company is one of the primary reasons that there have been attempts to limit stock option grants.

Another concern associated with stock options as a form of compensation is the dilutive effect that they have upon the ownership rights of existing shareholders. When stock options are exercised, each existing share of stock has a smaller claim on the company's net assets and profits; each existing owner's claim on profits and assets is therefore diluted as a

29. *See* I.R.C. § 162.

30. *See, e.g.*, Ruth Simon & Ianthe Jeanne Dugan, *Options Overdose Use of Stock Options Spins out of Control; Now a Backlash Brews*, WALL ST. J., June 4, 2001, at C1 (explaining that Cisco Systems reduced its taxes payable by $2.49 billion in fiscal 2000 because of option exercises, and overall, "162 large companies that reported options-related tax deductions in 1999 . . . reported a total of $15.3 billion in options-related tax savings").

31. *See* STEVEN G. SCHULMAN ET AL., THE SARBANES-OXLEY ACT: THE IMPACT ON CIVIL LITIGATION UNDER THE FEDERAL SECURITIES LAWS FROM THE PLAINTIFF'S PERSPECTIVE 292–93 (ABA Continuing Legal Education, 2002) (stating that one of the major concerns highlighted by the scandals at Enron, Global Crossing, WorldCom, and Adelphia is an abuse of stock options), *available at* SH097 ALI-ABA 281–292 (2002).

32. Michael E. Ragsdale, *Executive Compensation: Will the New SEC Disclosure Rules Control "Excessive" Pay at the Top?*, 61 UMKC L. REV. 537, 564 (1993); *see also Corporate Reform: Clambering Back Up*, ECONOMIST (London), July 20, 2002, at 53, *available at* 2002 WL 7246870 ("By fiddling with their accounts, company bosses could hope to drive up the share price, cash in their options, and set sail in their yachts.").

result of the option being exercised. In addition, the voting power of each outstanding share is reduced as options are exercised. As a simple example, consider a company with 100 shares outstanding. Each share represents 1 percent of the voting power, profits, and net assets. Now, if this company were to grant one option to an employee, there is a potential dilutive effect, but none is realized until the option is exercised. Once the option is exercised, however, there will be 101 shares outstanding, and each share will represent .99 percent of the voting power, profits, and net assets of the company. Most stock option plans have dilutive effects of less than 5 percent (meaning that the increase in shares outstanding is not more than 5 percent).[33] As a result of dilution, shareholders oppose many stock option plans, but those plans with minimal dilution often obtain shareholder approval because the potential benefits of stock options outweigh the potential risks associated with dilution, and because plans with minimal dilution are often exempt from shareholder votes.

II. LAWS AND REGULATIONS FOR SHAREHOLDER VOTING ON OPTION PLANS

In order to understand the new requirement that all shareholders be allowed to vote on stock option plans, it is necessary to understand the rules that existed prior to the change. There are at least four levels of requirements that companies must meet in order to comply with securities laws and regulations: state corporate laws, SEC regulations, stock exchange rules, and the Internal Revenue Code and regulations.

A. State Corporate Laws

State corporate laws afford shareholders little protection with regard to voting on stock option plans.[34] The Delaware General Corporation Law

33. *See* TIMOTHY M. HUNT & JASON D. MONTGOMERY, INVESTOR RESPONSIBILITY RESEARCH CENTER, VOTING BY INSTITUTIONAL INVESTORS ON CORPORATE GOVERNANCE ISSUES 37 (2001). For an example of shareholder concern with extreme dilution in a stock option plan, see Simon & Dugan, *supra* note 30. Simon and Dugan use the example of Citrix Systems, which sought shareholder approval of a new plan that would have enabled the company to grant enough options that each existing shareholder's dilution could have been up to 73 percent. Citrix defended this proposed option plan by stating that their plan was "within a range of multiple companies within the industry." *Id.* Even though the proposal passed the shareholder vote by a narrow margin, shareholders were able to prevent the plan from being implemented by seeking relief in the courts.

34. Prior to October 2000, New York afforded shareholders some of the best protection for stock option plans under New Business Corporate Law section 505(d). Before its amendment in

and the Model Business Corporation Act are representative of the statutes in most states, and these do not require shareholder approval of employee stock option plans. The only requirement in all jurisdictions is that shareholder approval must be obtained if the corporate charter is amended to increase the number of authorized shares of stock.[35] Thus, state statutes place very few requirements on corporations to obtain shareholder approval of stock option plans.

B. Securities and Exchange Commission Regulations

Section 16 of the '34 Act imposes elaborate reporting requirements on corporate insiders when they engage in any transaction involving their company's equity. Insiders also must report their activity in personal holdings of the company stock.[36] Rule 16b, a reporting requirement that is a part of section 16, prohibits insiders from profiting on short-swing sales.[37] The reporting requirements of Rule 16b are somewhat tempered by Rule 16b-3, which prior to 1996 allowed an exemption from the short-swing profit reporting rule for stock transactions made in connection with a formal employee benefit plan that shareholders had approved, either directly or indirectly. In 1996, Rule 16b-3 underwent a radical overhaul because it was found to be "intrusive in the area of corporate governance, and that compliance was unduly burdensome."[38] Under the reformulated Rule 16b-3, any transaction involving a grant, award or other acquisition of stock from the issuer is exempt if the transaction is approved by the company's

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2000, the statute required shareholder approval for the issuance of any options. *See* N.Y. BUS. CORP. LAW § 505(d) (McKinney 2003) (amended 2000). After the amendment of the statute, the only requirement in New York was that companies had to follow the policies of the stock exchange on which they were listed, or if the company was not listed, it had to obtain shareholder approval:

> The issue of . . . rights or options . . . shall be authorized as required by the policies of all stock exchanges or automated quotation systems on which the corporation's shares are listed or authorized for trading, or if the corporation's shares are not so listed or authorized, by a majority of the votes cast at a meeting of shareholders by the holders of shares entitled to vote thereon.

Id.

35. *See* Richard H. Wagner & Catherine G. Wagner, *Recent Developments in Executive Director, and Employee Stock Compensation Plans: New Concerns for Corporate Directors*, 3 STAN. J.L. BUS. & FIN. 5, 14 (1997).

36. *Id.* at 11.

37. In general, a short-swing sale occurs when a corporate insider has purchased and sold or sold and purchased his or her company's equity within a six-month period. *See* WILLIAM A. KLEIN ET AL., BUSINESS ASSOCIATIONS: CASES AND MATERIALS ON AGENCY, PARTNERSHIP, AND CORPORATIONS 512 (2003).

38. Wagner & Wagner, *supra* note 35, at 12.

shareholders, the securities acquired in the transaction are held by the person for a minimum of six months after the transaction, or the transaction is approved by the board of directors or a disinterested committee of the board.[39] It is important to note that the reporting requirements included in section 16 impose shareholder voting requirements on stock options granted to insiders of corporations, and that these voting requirements are minimal so as to not intrude into corporate governance. The rules and exemptions do not impose a shareholder voting requirement on stock options granted to employees who are not considered insiders. As a result of the amended Rule 16b-3, the SEC rules regarding stock option plans mostly concern section 16's reporting requirements.[40] However, corporations must still meet the requirements of the exchanges on which they are listed when they award stock options to employees.

C. Stock Exchanges

Prior to the latest rule change, all of the national stock exchanges had rules requiring shareholder approval of many stock option plans.[41] Before changes that began in 1997, the New York Stock Exchange (NYSE), the oldest of the major exchanges, required that companies seek shareholder approval for all stock option plans that were not broadly based. This meant that plans involving executives and ordinary employees were exempt from

39. 17 C.F.R. § 240.16b-3(d) (2003). It is important to note that the Sarbanes-Oxley Act of 2002, which was approved by Congress and signed into law by President Bush, included sweeping changes to section 16 of the '34 Act. This act amends section 16(a) to require more frequent and faster filing of documentation with the SEC, but does not change the exemption granted by Rule 16b-3. Transactions that meet the requirements of Rule 16b-3 are still exempt from section 16b liability, but the reporting requirements of these transactions will change dramatically. The effect of the Sarbanes-Oxley Act on insiders is that all stock transactions will have to be reported to the SEC on Form 4, and knowledge of the transaction will become public information within a few days of the transaction, instead of the prior situation where information was slow to become public knowledge. Sandra L. White, *The Effects of the Recent Amendments to Section 16 of the Exchange Act*, *in* WALL STREET LAWYER: SECURITIES IN THE ELECTRONIC AGE, Oct. 2002, at 14, 16.

40. *See infra* notes 64–66.

41. All three of the major stock exchanges have their own rules requiring shareholder voting on option plans. For the most part, the three major exchanges—the New York Stock Exchange (NYSE), NASDAQ, and AMEX—have changed their rules and regulations regarding stock option plans at the same time, out of fear that one exchange would have a competitive advantage over the others, leading to disparity for investors. *See* NASD Manual Online, *at* http://cchwallstreet.com/NASD (providing rules for NASDAQ); AMEX Constitution and Rules, *available at* http://wallstreet.cch.com/AmericanStockExchangeAmEX/. For purposes of this Comment, I will address only the NYSE rules and regulations, but the other exchanges have similar rules.

shareholder votes.[42] This exemption originally existed because the NYSE believed that any potential concerns regarding preferential treatment of officers or directors would be mitigated if the plan were available to the company's employees.[43] In 1997, the NYSE codified this exception for broadly based plans, and the SEC approved the change in early 1998.[44] Although there were no comments opposing this rule change, after the plan was adopted, there was a concern among investors, especially institutional investors, that companies would be able to design option plans under which they could avoid shareholder approval. As a result, the NYSE changed the definition of broadly based plans to allow the exemption if a majority of the company's employees could participate in the stock option plan.[45] This revised rule was a temporary solution to appease investors while a better, more workable rule was developed. In 2001, the broadly based rule was once again changed to include more option plans.[46] Even with the tightening of the rules, there still remain loopholes through which companies

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42. *See* Margaret M. Foran, *Current Issues Concerning Stock Options*, *in* COUNSELING THE CORPORATE BOARD & AUDIT COMMITTEE IN AN ERA OF CHANGE: SEC DISCLOSURE & THE INTERSECTION OF CORPORATE GOVERNANCE, 2002, at 309, 336 (PLI Corp. Law & Practice Course Handbook Series No. B0-01EO 2002), *available at* WL 1283 PLI/Corp 309.

43. *See id.*

44. The codification that occurred in 1998 explicitly defined the term "broadly based" in the NYSE Listed Company manual as a plan that "includes other employees." *Id.* at 338. Prior to this, there had been no definition of what constituted a broadly based plan, only an exception in Paragraph 312.03 of the manual. Therefore, Paragraph 312.04(g) was added to list the requirements necessary to qualify as a broadly based plan as depending on a variety of factors, and there was a safe harbor in this paragraph that allowed the exemption "if at least 20 percent of the company's employees are eligible to receive stock or options under the plan and at least half of those eligible are neither officers nor directors (the '20 percent test')." *Id.*

45. Paragraph 312.04(g) was replaced with 312.04(h) under this change. *See id.* The text of the amended paragraph follows:

> A Plan is "broadly-based" if, pursuant to the terms of the Plan: at least a majority of the company's full-time employees in the United States, who are "exempt employees," as defined under Fair Labor Standards Act of 1938, are eligible to receive stock or options under the Plan; and at least a majority of the shares of stock or shares of stock underlying options awarded under the Plan, during the shorter of the three-year period commencing on the date the Plan is adopted by the company or the term of the Plan, must be awarded to employees who are not officers or directors of the company.

U.S. SEC. & EXCHANGE COMM'N, NOTICE OF FILING OF PROPOSED RULE CHANGES BY THE NEW YORK STOCK EXCHANGE, INC., RELATING TO SHAREHOLDER APPROVAL OF STOCK OPTION PLANS (Security Exchange Commission Release No. 34-40679), *available at* 1998 WL 788860.

46. The current rule includes an exemption for broadly based plans, but also includes an exemption from shareholder approval for any plan that provides that no single officer or director may acquire more than 1 percent of the shares of a company's common stock outstanding at the time the plan is adopted, and that together with all other exempt plans, the dilutive effect is no greater than 5 percent of the company's common stock outstanding. *See* NEW YORK STOCK EXCHANGE, LISTED COMPANY MANUAL § 312.03 (2003), *at* http://www.nyse.com/listed.

can grant options without seeking shareholder approval.[47] The effect of these changes has been to weaken the protections for shareholders and to allow companies to grant stock options without seeking shareholder approval.

D. Internal Revenue Code and Regulations

Companies can seek shareholder approval of stock option plans to obtain tax benefits, but unlike other laws, this approval is discretionary. As discussed earlier, in order for a company to claim a tax deduction for stock options to executives in excess of the Internal Revenue Code section 162 $1 million threshold, the stock options must be granted under a shareholder-approved plan.[48] A company can choose not to seek shareholder approval of an option plan, but then the company will not be able to obtain favorable tax treatment.

E. The Need for Better Laws and Regulations

As can be seen from the different levels of regulation imposed on companies, state law and the SEC provide very few rules that mandate that shareholders vote on stock option plans. The main protections afforded to shareholders come from the exchanges on which companies are listed, and even these protections are minimal. With few restrictions in place, it is plain to see that companies, and especially directors and executives who run companies, can manipulate stock option plans to avoid shareholder approval. When management acts in the best interests of shareholders, there is no need to fear abuse of the existing laws. However, action by management that diverges from the interests of shareholders is a risk in the

47. One loophole that companies have resorted to in recent years has been to avoid shareholder approval of option plans by financing the plans with treasury stock. In this way, the dilutive effect of the option plan is said to be minimized because the shares granted as part of the option plan are simply those that have been repurchased by the company. *See* Kathleen Pender, *Tougher Option Rules Proposed*, S.F. CHRON., June 9, 2002, at G1. The result of these loopholes and minimal standards by states, the SEC, and the exchanges has been that the number of stock plans being put to shareholder vote is decreasing. The number of stock plans submitted to shareholders for votes in 2001 was 23.5 percent below the all-time high set in 1999. This drop has been attributed to both the relaxed rules and a depressed economy, resulting in less need for stock options. *See* Patrick S. McGurn & Jill Lyons, *Executive Pay: When Did Risk Become a Dirty Word*, *in* PREPARATION OF ANNUAL DISCLOSURE DOCUMENTS 2002, at 241, 246 (PLI Corp. Law & Practice Course Handbook Series No. B0-018D 2002), *available at* WL 1286 PLI/Corp 217.

48. *See* I.R.C. § 162(m)(4)(C) (2000). It is also worthwhile to note that in order for employees to have the ability to treat their options as ISOs, the options they receive and exercise must also be granted under a plan approved by shareholders. *See* I.R.C. § 422(b)(1).

modern corporation, and consequently, there is potential for the abuse of stock options for personal gain.[49]

As a result, there should be stricter requirements governing the granting of stock options to executives because it is currently possible for executives to receive large grants of stock options without shareholder approval by utilizing the exceptions contained within the rules. The major exchanges have approved regulations mandating shareholder approval of all option plans, as discussed earlier, because they believe it is desirable for shareholders to vote on the stock options that executives and management receive. This change, however, goes too far in attempting to protect shareholders by mandating that they vote on all option plans.

III. POTENTIAL CHANGE

A. Shifting Power From the Board of Directors to Shareholders

The NYSE regulations will result in a shift of power from the board of directors and compensation committees to shareholders. In most corporations, the board of directors has responsibility for determining the components and amount of executive compensation. The board usually delegates this responsibility to a compensation committee that consults with outside consultants and the company's human resources department.[50] As a result of corporate scandals in 2001 and 2002, compensation committees are extremely diligent in their reviews of compensation.[51] Therefore, when a committee recommends the appropriate compensation to the board of directors, the compensation recommendations are normally approved without

49. *See, e.g.*, BAINBRIDGE, *supra* note 15, § 1–5, at 35–38 (commenting that agency costs are an inevitable consequence of vesting a person other than the owner with power, and that the proper mix of authority and accountability is a central question in corporate governance).

50. This compensation committee is usually comprised exclusively of non-employee directors. *See* Randall S. Thomas & Kenneth J. Martin, *The Effect of Shareholder Proposals on Executive Compensation*, 67 U. CIN. L. REV. 1021, 1026 (1999). A study in 2000 by Korn/Ferry International found that the average number of inside directors on a compensation committee was zero and that the average number of outside directors was three. KORN/FERRY INTERNATIONAL, *supra* note 12, at 13. This study also found that 99 percent of companies have a compensation committee. *Id.* The NYSE's rules also include a provision that requires that the board of directors create a compensation committee composed solely of independent directors who, at a minimum, would determine the CEO's compensation. *See* Bainbridge, *supra* note 7, at 376–77.

51. *See* Petruno & Kristof, *supra* note 10 ("But consultants who work with board compensation committees . . . say the corporate scandals of the last two years, the heightened focus on pay levels and the threat of lawsuits have left those individuals fully aware of their responsibilities.")

much inquiry.[52] It is the executives, in consultation with the board of directors, who then have the responsibility for determining the amount and composition of pay for managers and rank-and-file employees. Throughout the period when compensation is being determined, shareholders have no direct input on the amount or components of compensation. The influence of shareholders is much more indirect because the board of directors in accepting any compensation package is aware that most compensation packages including stock options will require shareholder approval.[53]

Requiring shareholder voting on all stock option grants will change the dynamics of power regarding compensation in every company. Shareholders will be more involved in the compensation process because their voting will not only affect the structure of executive compensation, but also the compensation packages of every other employee within the company. The power to determine executive compensation is the role of the board of directors, and the role of shareholders is to elect the board of directors.[54] This new change will simply shift the power to determine compensation from compensation committees to shareholders. One commentator has argued that when dealing with corporate governance, "reforms that shift power from one party to another will not by themselves create more smoothly run, profitable organizations. The reasons? They do not address the fundamental problems in corporate governance, which stem not from power imbalances but from failures in the corporate decision making process."[55]

B. Shareholders: Not Properly Positioned

This change by the major exchanges will give shareholders a major role not only in the determination of stock options for executives, but also in the determination of stock option compensation for all other employees within a corporation. Shareholders will ultimately have the power to veto the decisions of management regarding stock options, and this is something that

52. *See* Thomas & Martin, *supra* note 50, at 1025–27 (explaining the process of determining executive compensation and the role of the compensation committee and its advisors).

53. *See id.* at 1026–28.

54. *See* John A. Byrne, *Restoring Trust in Corporate America*, BUS. WK., June 24, 2002, at 30, 33 ("[M]aking sure that managers actually act in the best interests of shareholders is supposed to be the job of the board of directors."); *see also* Thomas & Martin, *supra* note 50, at 1032 ("Shareholders can also act as monitors of executive compensation. Although [shareholders] delegate substantial authority to the board of directors, they exercise ultimate control over the board and its agents through annual elections.").

55. John Pound, *The Promise of the Governed Corporation*, 73 HARV. BUS. REV. 89, 89–90 (1995).

most shareholders are not equipped to handle. There are many reasons why shareholders are not well positioned to determine pay for those within the corporation: The complexity of compensation schemes and the cost of understanding them are beyond the ability of the average shareholder; ordinary business decisions should be made by the company's management, not shareholders; and a diversified shareholder will have many corporate compensation packages that require monitoring and voting.

1. Complexity and the Cost of Information

The structure of corporate governance recognizes the fact that shareholders have a limited ability to gather and analyze the information necessary to make informed decisions regarding employee compensation. This is a major reason for the delegation of power to the board of directors. One concern is that there are many different levels of knowledge among those who own stock.[56] However, in order to make adequate business decisions regarding compensation and the use of stock options, it is necessary for all decisionmakers to be able to access and analyze the proper information. As one commentator has suggested:

> Shareholders are not . . . well-equipped to act as monitors of . . . compensation. Compensation plans are complex, technical documents that cannot be readily understood without a substantial amount of knowledge about the intricacies of different types of pay programs. . . . Shareholders cannot expect to have the same level of access to information [as management].[57]

It is not reasonable to expect that every shareholder will be able to make informed decisions regarding compensation for individuals within the firm. Even if we were to assume that shareholders have the capacity to understand

56. One commentator has suggested that there are four levels of investors in the marketplace, and that a test should be administered to the sixty-five million investors in the United States to determine their qualifications to invest in the stock market and make business decisions for companies. *See* Robert Prentice, *Whither Securities Regulation? Some Behavioral Observations Regarding Proposals for Its Future*, 51 DUKE L.J., 1397, 1404–08 (2002) (reviewing Stephen Choi's shareholder proposal, Stephen Choi, *Regulating Investors Not Issuers: A Market-Based Proposal*, 88 CAL. L. REV. 279 (2000)). The different levels suggested include: unsophisticated investors who should basically have no autonomy in the marketplace; aggregate-level investors who can make some, but not all decisions on their own; intermediary-level investors who can make investment decisions, but should not deal directly with the company itself; and finally, issuer-level investors who are the most sophisticated investors in the marketplace. *Id.* Although testing investors to determine their ability to vote and become involved in company affairs is one way to account for the difficulties of having shareholders vote on compensation issues, I believe that testing is neither efficient, equitable, nor realistic given the ease of becoming involved in the stock market today.

57. Thomas & Martin, *supra* note 50, at 1033.

the issues a firm encounters, the cost of the information is prohibitively high to both corporations and investors.[58] Not only would corporations be required to spend vast amounts of time and money to educate investors to enable them to make informed decisions, but investors would also have to expend their own resources to fully comprehend the company's compensation proposals.[59] Moreover, involving every shareholder would create additional costs because the process for including shareholders in decisionmaking is necessarily expensive.[60] One final assumption that would have to be made is that the corporation would provide all the information necessary for investors to make informed decisions and that

58. *See Governance Changes Boost Proxy Costs*, INVESTOR REL. BUS., July 29, 2002, at 1 (arguing that at companies with a large proportion of individual investors, it will be costly and require many resources to inform investors and gather the necessary votes for plans that currently do not require voting by shareholders); Choi, *supra* note 56, at 302 ("To become informed, investors require both adequate informational resources and the expertise to interpret this information. Information, however is costly; even when provided freely, most investors have only limited ability and desire to read and analyze all relevant investment information on different companies."). The cost of gathering and disseminating information if stock option plans are voted on by shareholders will be quite significant. When the SEC proposed changes to the disclosure requirements surrounding stock options in forms 10-K, Schedule 14A, Schedule 14C, and other various disclosure documents, the cost of the additional disclosures was estimated to be thousands of internal hours for document preparation by corporations and millions of dollars in additional expenditures to legal counsel to ensure compliance with the requirements. U.S. SEC. & EXCHANGE COMM. PROPOSED RULE, DISCLOSURE OF EQUITY COMPENSATION PLAN INFORMATION (Sec. and Exchange Comm'n Release Nos. 33-7944, 34-43892, Jan. 26, 2001), *reprinted in* PREPARATION OF ANNUAL DISCLOSURE DOCUMENTS 2002, at 181, 187–89 (PLI Corp. Law & Practice Course Handbook Series No. B0-018D, 2002), *available at* WL 1285 PLI/Corp 111. One can only imagine what the cost associated with shareholder voting would be based on these expenditures for disclosure.

59. It is not likely that shareholders would be willing to invest their own resources to make informed decisions because "a rational shareholder will expend the effort to make an informed decision only if the expected benefits of doing so outweigh its costs." BAINBRIDGE, *supra* note 15, § 10.4, at 485. In connection with voting on stock option plans, shareholders would likely have a huge cost to become informed, but would receive little benefit, especially if they have only a small holding in a corporation.

60. *See* Eric L. Johnson, *Waste Not, Want Not: An Analysis of Stock Option Plans, Executive Compensation, and the Proper Standard of Waste*, 26 J. CORP. L. 145, 169 (2000). Eric Johnson explains that in companies with small numbers of shareholders, there is not a problem of shareholder decisionmaking because "one owner can effectively decide to act and discipline managers," but "[t]he more owners a corporation has, the more the collective action problem grows because the diverse shareholders are unable to effectively coordinate among themselves to monitor and discipline managers." *Id.*; *see also* Thomas & Martin, *supra* note 50, at 1038. Thomas and Martin argue that shareholders would also be limited in their efforts to affect compensation because they would be unable to coordinate their efforts and form coalitions to work together to produce change: "Coordinated shareholder action on matters such as executive compensation is hard to achieve successfully. Widely dispersed shareholders face significant collective action barriers, including the high costs and limited rewards of individual action." *Id.*

the company would not withhold information to get a plan approved.[61] Because of these high costs and information problems, shareholders are not the proper party to make these decisions. Current corporate governance techniques have established the board of directors as the monitor of compensation within the firm, and shareholders control the board of directors by voting on its members.

2. Ordinary Business Decisions Should Not Be Made by Shareholders

The information problems related to compensation explain why shareholders should not make the everyday business decisions of a corporation. While it seems appropriate that shareholders should have some voice in compensation decisions, it does not seem appropriate that decisions for ordinary operations such as non-executive compensation should be made by shareholders. Staunch shareholder advocates have even gone on record as saying that their intent is not to "micromanage" corporate pay and that their main concern is dilution.[62] The concern about shareholders managing the day-to-day operations of corporations is recognized in the fact that they are not involved in decisions for compensation involving only cash. Whereas stock options lead to dilution, cash compensation also reduces the profitability and cash flow attributable to each share of stock. If shareholders are allowed to vote on all stock option compensation, then it would seem to be only a matter of time until shareholders are able to vote on cash compensation for all employees,

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61. *See* BAINBRIDGE, *supra* note 15, § 10.3 at 464–65. Commenting on the information asymmetries that exist in large corporations, Bainbridge writes, "As a practical matter, of course, our employee-shareholders are not going to have access to the same sorts of information. . . . These information asymmetries will prove intractable." *Id.* Considering the dollar amounts at stake in many compensation proposals, it is a questionable assumption to believe information will be fully disclosed.

62. *See* Thomas & Martin, *supra* note 50, at 1032 ("[S]hareholders should not attempt to dictate how the corporation conducts its day-to-day business, or otherwise engage in micromanaging the corporate enterprise."); Kathy Kristof, *Outgoing SEC Chief Urges Shareholder Say on Stock Grants*, CHI. TRIB., Jan. 28, 2001, at 3 (quoting Ann Yerger, the director of research for the Council of Institutional Investors, a shareholder watchdog group, as saying that "[o]ur members don't want to micromanage pay levels, but we do want to make sure that there is adequate disclosure and that shareholders have adequate protection to look over these plans"); *see also* Byrne, *supra* note 54, at 35 (quoting Frank Raines, the CEO of Fannie Mae and chairman of the Business Roundtable's Task Force on Corporate Governance, part of a group of corporate executives who weigh in on public policy issues, as saying that "[m]anagement should have some flexibility in using the stock if it's compensation for a large number of employees").

because cash compensation affects the ownership stake of each shareholder, arguably more so than stock options.[63]

The SEC and the states have recognized that policing compensation is a matter for the board of directors. The SEC recognized that shareholders should not be as involved in the determination of compensation with amendments to Rule 16b-3 in 1996 that were made to reduce the intrusiveness of the SEC regulations into the operations of a company.[64] In addition, until 1992, the SEC allowed corporations to bar shareholder proposals regarding executive compensation from being voted on because the SEC viewed these as ordinary business matters that were subject to exclusion.[65] The SEC, however, still allowed companies to exclude compensation issues for non-executives from being proposed for a shareholder vote because they were seen as ordinary business matters. It was only in July 2002 that the SEC allowed shareholder proposals on all option plans to be included on the ballot.[66] This change by the SEC to allow shareholder proposals for stock option grants to come up for a vote in no way indicates that shareholders should have the right to vote on all option plans. The SEC history on this issue shows deference to management in making business decisions without shareholder involvement. This suggests that in egregious situations in which shareholders believe that management has erred, shareholders have the right to propose a vote on the decision of management to change the corporation's stock option policy.

In addition to the SEC, state and federal courts have acted to protect the business decisions of the board of directors and executives. Courts do not interfere with the business decisions of corporations regarding compensation because they tend to feel that the board of directors and executives are in a better position to determine compensation.[67] In Delaware,

63. *See* Michael S. Katzke, *Executive Compensation: Shareholder Approval of Equity Plans*, INSIGHTS, Feb. 1997, at 2, 2 (stating that shareholders are not involved in the determination of cash compensation).

64. *See supra* notes 36–39 and accompanying text; *see also* Katzke, *supra* note 63, at 2 (stating that the SEC amendments to Rule 16b-3 were a positive step towards recognizing that corporate governance policies and the board of directors, and not shareholders, were the proper place to police compensation policy).

65. *See* Thomas & Martin, *supra* note 50, at 1045–46. The reason the SEC allowed executive compensation matters to be subjected to a vote when proposed by shareholders was because "executive compensation issues had become the focus of widespread public attention and debate so that they were no longer in the realm of ordinary business matters." *Id.* at 1046.

66. *See Shareholder Activists Turn up the Heat After Enron*, INVESTOR REL. BUS., July 29, 2002, at 1 (stating that the SEC reversed its position after years of calling stock option grants ordinary business matters that were not subject to shareholder vote proposals).

67. *See, e.g.*, Randall S. Thomas & Kenneth J. Martin, *Litigating Challenges to Executive Pay: An Exercise in Futility?*, 79 WASH. U. L.Q. 569, 602 (2001) ("Boards of directors are better

shareholders may bring a derivative suit against the board of directors for a violation of fiduciary duties, but the bar is set extremely high for shareholders to proceed.[68] In order to bring a lawsuit against the board of directors, a shareholder must first meet the demand requirement: The shareholder must demand that the board take corrective action, or else demonstrate that making such a demand would have been futile by creating doubt about the independence of the board and the validity of its decision.[69] The second requirement that a shareholder must meet in a Delaware derivative action is to show the decision of the board of directors was not "the product of a valid exercise of business judgment," thus overcoming the presumption of the business judgment rule that ordinarily protects management from liability for business decisions.[70] Another alternative for the disgruntled shareholder seeking judicial intervention to stop a stock option plan would be to claim that the decision of the board of directors, while not a violation of the board's fiduciary duties, constitutes waste. The waste standard has undergone continual change for the past fifty years in Delaware, but the current standard affords the board of directors wide latitude with regard to stock options: whether the consideration received for the payment is so inadequate that no person of ordinary, sound business judgment would deem it worth what the corporation paid.[71] This interpretation was adopted by the Delaware courts because it is a better way to monitor compensation than making judicial determinations of fairness or soundness of consideration.[72] Whether a shareholder attempts to sue the board of directors for a violation of its fiduciary duties or for committing waste, courts and legislatures "have constructed procedural obstacles because they have recognized the importance of limiting the review of business decisions in the courts."[73] Even

suited than courts for making determinations about the appropriate levels of . . . compensation. Directors are more knowledgeable than judges about their companies' needs and the market for . . . talent.").

68. One way in which the board of directors can avoid a possible suit by shareholders over stock option plans on the grounds that they have violated their fiduciary duties is to put the plan to a vote by the shareholders. *See* Johnson, *supra* note 60, at 154 ("Courts have found that a board of directors may immunize itself in litigation involving violations of the duty of care or loyalty by having shareholders ratify any questionable transaction. . . . [I]t is in the board's best interest to ratify a plan in order to protect itself in potential future litigation.").

69. *See* Brehm v. Eisner, 746 A.2d 244, 254–55 (Del. 2000); Aronson v. Lewis, 473 A.2d 805, 814 (Del. 1984).

70. *See Aronson*, 473 A.2d at 815.

71. *See* Johnson, *supra* note 60, at 155–67 (explaining the different interpretations of waste during the past fifty years and the reason for settling on the current definition of waste).

72. *See* Lewis v. Volgelstein, 699 A.2d 327, 338 (Del. Ch. 1997).

73. Mark J. Loewenstein, *Reflections on Executive Compensation and a Modest Proposal for (Further) Reform*, 50 SMU L. REV. 201, 210 (1996).

though the judiciary is the ultimate champion of fairness, the courts tend not to second-guess business decisions, generally deferring to the judgment of the board of directors and management.[74] One reason for doing this is because courts do not possess the proper information to make business decisions. It seems odd, therefore, that shareholders would be in the appropriate position and would possess the necessary information to make business decisions that courts have said are better left to the board of directors and management.

In the latest stock exchange rule changes, there is an emphasis on the idea of independence by the board of directors and trying to rein in the use of stock options by executives so that the abuses that caused the bankruptcy of companies such as Enron, Adelphia, and WorldCom can be prevented. Not only is the historical power of determining compensation being taken out of management's hands, but these changes seem to make little sense when applied to all employees.[75] Increasing control over the use of options by executives is understandable, but reducing options for the rank and file will not have a major effect on corporate governance and honesty.[76] The average worker has little power within the company and the stock market to manipulate the price of a stock, unlike an executive like Kenneth Lay of Enron, who could mislead analysts and investors alike by claiming that his company was performing well.[77] As one commentator has stated: "For all

74. *See generally* Thomas & Martin, *supra* note 67 (discussing the courts' reluctance to tell businesses what constitutes reasonable compensation).

75. They make such little sense that even before the regulations were issued by the NYSE, the Business Roundtable, a group of chief executives from Fortune 500 companies, vehemently opposed regulations that would require "blanket approval of all plans, saying it could result in fewer stock options for rank-and-file employees." Pender, *supra* note 47. The Business Roundtable subsequently dropped its public opposition to the regulations over concerns of loss of investor confidence, even though many members of the roundtable still had lingering private concerns regarding the proposed changes. *See* Phyllis Plitch, *Business Roundtable Supports SEC Move to Certify Financials*, WALL ST. J., July 9, 2002, at C11, *available at* 2002 WL-WSJ 3400016.

76. The proposals seek to address this concern by requiring shareholders to vote on all stock option plans because executives and management are currently able to group their stock options with those of other employees and become exempt from a shareholder vote. However, rather than voting on all stock option plans, it would be much more conducive to business operations if shareholders would vote only on those stock option plans that included management and executives.

77. *Compare* Jeffrey N. Gordon, *What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections*, 69 U. CHI. L. REV. 1233, 1233–34 (2002) (stating that less than six weeks before Enron filed for bankruptcy protection, Kenneth Lay reassured investors that Enron was financially solid, and investors took this to be an indication that the problems were not as grave as the media reported), *with* Byrne, *supra* note 54, at 30 (quoting the chairman of the Business Roundtable's Taskforce on Corporate Governance as saying, "[t]here is no danger of acting in a self-serving way if management is not a participant in the plan").

but senior management, the action of any individual employee will have [a] negligible impact on the stock price."[78] The major concern for existing shareholders with stock options being used for ordinary employees should be the potential for dilution, and not the potential for abuse. Given the current atmosphere, in which stock option plans are clouded with negative publicity, they could be rejected by uninformed investors who do not consider the proposals sufficiently. It seems likely that imposing mandatory voting on all stock option plans will severely impact non-executives, a group that the change is not intended to affect.

3. The Problems for a Diversified Shareholder

Another reason that shareholders should not be called upon to make ordinary business decisions for the corporation is because each particular shareholder has diverse holdings. As mentioned above, it is quite difficult for an investor to obtain and digest information about a single company so that he or she will be in the proper position to make an informed decision regarding compensation.[79] Now imagine the complexities for a shareholder who maintains a diversified portfolio.[80] The amount of information necessary for the shareholder would increase, and the complexity would be greater, because the shareholder would not have specialization in any industry. Every industry has a wide variety of competitive challenges, and as a result, compensation packages will be different not only between companies, but also between industries.[81]

C. Will Shareholders Vote Against Stock Option Plans?

Even if shareholders fully understand the decisions facing them, the fact that they can vote on option plans does not mean that they will vote against the plans. Studies indicate that shareholders approve most option

78. Gordon, *supra* note 77, at 1247.

79. *See supra* notes 61–66.

80. *See, e.g.*, *Do-It-Yourself Investment Fiduciary*, 34 MD. B.J. 54, 55–56 (2001) (stating that the risk is minimized and returns are stabilized by having a diversified portfolio and that the benefits of diversification become even greater when the number of stocks in a portfolio increases).

81. *See* Thomas & Martin, *supra* note 50, at 1033 ("Each industrial sector has its own unique competitive challenges. As a result, different industries use executive compensation packages exhibiting a wide variety of components. Even within an industry, the individual companies will have . . . compensation plans tailored to their particular situation.").

plans when they have the opportunity to vote.[82] In addition, shareholders are not directly opposed to compensation plans that include stock options. Major stockholders believe that stock options are a valuable component of compensation. One example is found in the Teachers Insurance and Annuity Association College Retirement Equity Fund's policy statement that reads: "Stock-based compensation plans can be a critical element of compensation programs, and can provide the greatest opportunity for the creation of wealth for the managers whose efforts contribute to the creation of wealth for shareholders."[83] Large institutional investors understand the benefits that can come from the aligned incentives brought about by stock options, and if given the opportunity to vote on every option plan, they would be likely to approve most of them. The major concerns of most investors are option plans that have a large amount of dilution or give executives large numbers of shares that could lead to fraud or mismanagement.

Aside from potential abuse by executives, one of the largest areas of concern for both small and large investors when dealing with stock option plans is the potential for dilution. As mentioned earlier, dilution occurs in stock option plans because the number of shares outstanding increases, and existing shareholders see their power diminish as a result of granting stock options.[84] In a study by the Investor Responsibility Research Center (IRRC) using data from 2000, proposals to establish, amend, or add shares to stock option plans were the most frequently occurring voting decisions facing shareholders after the routine matters of election of directors and the ratification of auditors.[85] This study found that the main reason that institutional investors voted against stock option proposals was because of dilution that exceeded a certain level. The finding was that when potential

82. In one study for the 1997 voting season, there were 1926 stock plans proposed by more than 6000 companies that held shareholder meetings. Of those 1926 plans, nearly 1000 (more than 50 percent) were approved with less than 10 percent of the shareholders voting against the plans, and nearly 1500 (more than 75 percent) were approved with less than 20 percent of the shareholders voting against the plans. Only 6 plans out of the 1900 presented to shareholders were not approved. *See* Richard H. Wagner, *Obtaining Shareholder Approval of Stock Plans*, INSIGHTS, Dec. 1997, at 13.

83. TEACHERS INSURANCE AND ANNUITY ASSOCIATION COLLEGE RETIREMENT EQUITY FUND, POLICY STATEMENT ON CORPORATE GOVERNANCE (2001), *reprinted in* HOT ISSUES IN EXECUTIVE COMPENSATION, at 353, 360 (PLI Corp. Law & Practice Course Handbook Series No. J0-004F 2001), *available at* WL 503 PLI/Tax 351. *But see* Useem, *supra* note 24, at 70 (stating that mutual fund giants such as Fidelity Investments and Vanguard intend to take a tougher line against excessive executive compensation, and Vanguard has even warned that it voted against some stock-based compensation proposals).

84. *See supra* note 33.

85. *See* HUNT & MONTGOMERY, *supra* note 33, at 30.

dilution was less than 5 percent, 95 percent of investors would not vote against the proposal, and only if dilution exceeded 10 percent would a majority of investors vote against a stock option plan.[86] The rules in place at the major exchanges prior to the latest change mandated that when the dilutive effect of a plan combined with other plans exempt from shareholder approval exceeded 5 percent, the plan must be submitted to shareholders for a vote. The results of the IRRC study could very well be the reason that the major exchanges used the 5 percent dilution exemption in their rules. After all, if shareholders usually do not oppose a stock option plan with less than 5 percent dilution, then a shareholder vote would not make a noticeable difference in the number of stock option plans that get approved. The IRRC study indicates that requiring shareholders to vote on all stock option plans for every company will not greatly affect the number of plans that get approved, and that many of the problems associated with stock options will still exist.

Additionally, voting for all option plans will not significantly alter the rate at which option plans are implemented because institutional investors, executives, and directors control the majority of stock in corporations.[87] In very few circumstances is it realistic to believe that an executive would vote against a stock option plan that would increase his or her pay. As a result, it can be expected that the stock owned by executives will be used to vote in favor of the option plan.[88] Although the percentage of company stock owned by executives is not all that significant, the percentage of stock owned by mutual funds is quite substantial. In 2000, mutual funds owned more than 21 percent of equities in the United States, and these investors owned more than 50 percent of the stock in the one hundred largest U.S. companies.[89] Mutual funds have begun to realize the importance of corporate governance and voting with the interests of investors in mind,[90] although

86. *See id.* at 36–38.

87. *See* Thomas & Martin, *supra* note 14, at 50 n.98.

88. The amount of stock owned by executives and directors of large American companies averaged 3.5 percent in 2000. However, this number would be 11.9 percent if "already authorized, but unissued and already granted, but unvested, stock options are actually granted and exercised." *Id.*

89. *See* Alan R. Palmiter, *Mutual Fund Voting of Portfolio Shares: Why Not Disclose?*, 23 CARDOZO L. REV. 1419, 1426–27 (2002) (stating that institutional investors typically prefer to invest in large companies, and that the limitation of an individual mutual fund owning no more than 10 percent of any one company is circumvented because mutual funds in the same family under common management can exceed the 10 percent limit, as each fund is considered independent).

90. *See* Beth Healy, *Big Investors Assuming a More Activist Stance*, BOSTON GLOBE, July 11, 2002, at C1. The author reports that Fidelity Investments, which manages nearly

the overwhelming belief is that mutual funds vote in agreement with the management of a company.[91] There have been many reasons offered as to why mutual funds have chosen not to get too involved in corporate governance: Mutual funds are short-term investors and therefore focus on investment for short-term gain rather than governance; mutual funds fear offending the management of a company in which they invest because they rely on management for information; mutual funds can free-ride on the activism of other shareholders; mutual funds are limited in the percentage of a company that they can own, and therefore do not have clout with any one company to engage in corporate governance issues; and mutual funds seek to avoid unreimbursed activism costs.[92] This last point is extremely important—mutual funds will not engage in activism because of the high costs of doing so and because "mutual fund managers view their role as running portfolios, not companies."[93] Thus, even when they have the right to vote on all stock option plans, mutual funds will likely continue to vote in accordance with the wishes of company management if an option plan would not lead to excessive dilution for existing shareholders.[94] Therefore,

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$800 billion—had "long held that [it was] best to vote with one's feet" by selling shares if they disagreed with company policy, but because unethical executives can fool even the savviest of investors, "mutual funds and pension funds are rising up to insist that standards be raised at public companies in order to protect investors." *See generally* Palmiter, *supra* note 89, at 1435–41 (finding that some mutual funds have recently begun to be active and effective in governance and that many money managers have a growing awareness of their potential to shape corporate governance through their large ownership stakes).

91. *See* Robert McGough & Pui-Wing Tam, *Bogle Urges Role in Corporate Governance*, WALL ST. J., Oct. 21, 1999, at C23. John Bogle, chairman of the Vanguard Group, was quoted as saying that mutual funds have failed "'to live up to their responsibility of corporate citizenship'" and that "funds haven't wielded their voting power to oppose management on issues such as excessive stock-option issuance, option repricing and earnings that are smoothed by accounting gimmicks." This belief is given even greater credence by many corporate activists because there are no statutes or regulations requiring disclosure of mutual fund voting, and mutual funds do not make voluntary disclosures. "The only . . . disclosure of mutual funds' governance power is SEC mandated disclosure of funds' portfolio holdings." Palmiter, *supra* note 89, at 1441–42.

92. *See* Palmiter, *supra* note 89, at 1431–34.

93. *Id.* at 1433; *see also* Andrew Brent, *Mutual Funds Mull Activism to Restore Market Confidence*, INVESTOR REL. BUS., July 15, 2002, at 1 (arguing that in the current economic climate, mutual funds can attract investors by taking on a more activist role, but that corporations should not worry about involvement by mutual funds because "it isn't in fund managers' interests to obstruct companies' business operations").

94. One aspect of voting by shareholders that will change under the latest reforms is that brokers will no longer be able to vote for the shares they hold if they do not hear from the beneficial owners. Previously, the NYSE listing standards permitted a broker to vote on behalf of a beneficial owner if the broker had not received instructions from the beneficial owner by the date specified in the proxy statement. *See* NEW YORK STOCK EXCHANGE, *supra* note 46, at § 402.08(A)(2) (2003); *see also* *Governance Changes Boost Proxy Costs*, *supra* note 58, at 1 (stating that currently, companies can rely on shareholder approval for routine matters because brokers

the latest rule change by the major exchanges will have little effect in preventing executives from obtaining stock options.

D. Loopholes Already?

The rule adopted by the major exchanges is overinclusive in that it will affect all corporate employees, yet it is also underinclusive in that it is the potential for abuse in some of the exceptions. One of the exceptions in the latest rule permits companies to grant stock options as inducements to employees or executives if the grants are approved by an independent compensation committee or a majority of the company's independent directors.[95] Already, there has been criticism of this exception because it will lead to excessive stock option grants for newly hired executives.[96] The potential for abuse from use of this exception is great because an executive who switches from one corporation to another will be able to extract a large premium of stock options given that this will be the only time that the executive is able to obtain stock options without shareholder approval.[97] The danger of abuse is alarming because the stock option grant would only have to be approved by an independent compensation committee or a majority of the independent directors, regardless of the potential dilution. Under the current rules, even though an option grant could be exempt from shareholder approval because it is broadly based, shareholders would at least be able to vote on the plan if there is excessive dilution. This rule is meant to protect investors, but the potential abuse of this one exception could ultimately lead to more harm to investors.

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can vote on behalf of their account holders, and this can contribute 30 to 40 percent support immediately without any effort by the company); Phyllis Plitch, *NYSE Change Seen as Boon for Holders*, WALL ST. J., June 19, 2002, at B11F (stating that up to 80 percent of all shares are held by brokers and banks on behalf of investors and that these shares are typically voted in accordance with management's wishes by brokers and banks on behalf of stock option plans with potential dilution of less than 5 percent of a company's outstanding shares).

95. *See* NYSE GOVERNANCE RULE PROPOSALS, *supra* note 6, at 13.

96. *See, e.g.*, *NYSE Approves New Governance Rules*, *supra* note 1 ("I'm afraid that this is going to encourage more and more companies toward even more ridiculous grants to executives." (quoting Ann Yerger, director of the Council of Institutional Investors)).

97. It is not unlikely that companies, when looking for executives, will hire from outside the company as opposed to hiring from within, thus enabling a large number of options to be granted without shareholder approval. The average time that a CEO is in the position with any company is three years, and corporate boards are expected to hire CEOs with prior experience as a CEO. "[T]oo many boards demand someone who has already been a CEO somewhere else, to avoid the criticism that would follow if a rookie CEO didn't work out." Daniel Kadlec, *8 Remedies: Here's How to Restore Credibility and Help Reinvigorate the Stock Market*, TIME, June 17, 2002, at 50, 52.

Another potential loophole to avoid shareholder approval of stock option plans might exist if a company creates a tracking stock for a portion of the corporation's assets. Tracking stocks are shares that track a specific part of a company with a separately listed stock. The theory is that tracking stocks will "'unlock the hidden' value of a company's assets," or can be used as a tool to facilitate a merger or acquisition.[98] The problem, however, is that executives usually receive a number of options equal to their share in the parent in order to prevent bias by management towards one part of the company.[99] The rules are not specific on how they would treat the issuance of a tracking stock, but the rules have an exemption for options acquired in a merger.[100] Because shareholders are likely to approve a tracking stock based on the benefit to their personal portfolios, any conditions to allocate options to executives would likely pass. Tracking stocks were used regularly in the late 1990s, but have not been used very much in the early 2000s. They could possibly return to prominence, however, if executives begin to issue them for each individual piece of a company in order to maximize ownership of stock options.

CONCLUSION

The abuse of stock options by executives can have a detrimental effect on corporations because stock options create possible incentives for management to be less than forthright with investors and even those within the company. This problem came to the forefront with the bankruptcy filings of large corporations in 2001 and 2002, but it could become a bigger issue because of the prevalence of stock options as a part of compensation, especially for executives.[101] In adopting their latest rule change, the major

98. John A. Byrne, *Extra Helpings on the Gravy Train: Tracking Stocks Let Some Execs Double up on Their Options*, BUS. WK., Apr. 22, 2002, at 39; *see also* Jeffrey J. Schick, *Toward Transaction-Specific Standards of Directorial Fiduciary Duty in the Tracking-Stock Context*, 75 WASH. L. REV. 1365, 1371–72 (2000) (stating that tracking stocks are commonly used as parts of acquisitions and that "[t]he development of the Internet has fueled the popularity of tracking stock as a tool of acquisition").

99. *See* Byrne, *supra* note 98. The creation of tracking stocks has had a profound effect on executive pay, because the use of options on tracking stocks has dramatically increased CEO pay at some companies. For example, Sprint Corporation created one tracking stock for its long-distance telephone business and another for its wireless business, PCS, and after three years, seven of Sprint's top executives had realized gains of $185 million on their options alone. *See id.*

100. NYSE GOVERNANCE RULE PROPOSALS, *supra* note 6, at 13.

101. Corporations, however, have begun to use stock options even less for executives as a result of recent corporate scandals, with Microsoft and General Electric—two major corporations—saying they will no longer grant stock options for executives. *See* Petruno & Kristof, *supra* note 10. These corporations have merely pulled the plug on stock options to their

exchanges sought to address the concerns of corporations and also investors. But in attempting to please everyone, the exchanges failed to take the one step that would have definitely reduced the abuse of options in corporate compensation: treating options as a business expense for accounting purposes. The NYSE acknowledged in its latest changes that it did not address expensing stock options: "We note that guaranteeing shareholder control over plans may ameliorate some of the concerns of those in favor of changing the existing accounting treatment of stock options."[102] Although the FASB would ultimately have to determine whether stock options should be an expense, the NYSE could have exerted greater pressure on the FASB through its rules to require the expensing of stock options. The NYSE chose not to exert this pressure in order to address the concerns of many technology companies whose income statements could not stand the hit that would follow from expensing options.[103] One reason given for not requiring options to be expensed is that it would be extremely difficult to value the options, but considering the many intangibles that can be valued for financial statement purposes, it is not too much of a stretch to believe that the FASB could develop a consistent and accurate method to value options, especially if the NYSE exerted pressure. If corporations were required to expense options, then abuse would begin to slow, because companies would "have to choose between options and profits, [and would] be less likely to make excessive grants to undeserving CEOs."[104] The drive to expense options has strong backers such as Warren Buffet and Alan Greenspan, who maintain that expensing is the only way to avoid the abuse of stock options.[105]

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executives, but will still use them for their rank-and-file employees, bolstering the argument that control of stock option plans should remain with management instead of with shareholders. *Id.*

102. NEW YORK STOCK EXCHANGE CORPORATE ACCOUNTABILITY AND LISTING STANDARDS COMMITTEE REPORT 13 (June 6, 2002), *available at* http://www.nyse.com/pdfs/corp_recommendations_nyse.pdf.

103. The biggest opponents of expensing options have been technology companies, especially those based in Silicon Valley and other parts of the West Coast. The reason for this opposition is that whereas Coca-Cola's expense for stock options in 2001 would have been about $200 million, the expense for a technology company such as Cisco would have been $1.7 billion, enough to make all of Cisco's profits evaporate. *See Corporate Reform*, *supra* note 32, at 54.

104. Louis Lavelle, *How to Halt the Options Express*, BUS. WK., Sept. 9, 2002, at 74, 74.

105. *See* Bo Glasgow, *Corporate Governance: A Time for Change*, CHEMICAL MKT. REP., Aug. 19, 2002, at 24 (quoting Warren Buffet's belief that options should be an expense because "[w]hen a company gives something of value to its employees in return for their services, it's clearly a compensation expense, [a]nd if expenses don't belong in the earnings statement, where in the world do they belong?"); *Turmoil in the Stockmarkets: Fear, Then Greed*, ECONOMIST (London), July 27, 2002, at 61, *available at* 2002 WL 7246910 (explaining Alan Greenspan's view that reporting to shareholders is not as accurate as it could be because it does not include stock options).

My hope is that these new rules will reduce the abuse of stock options by executives and will restore confidence to the shattered financial markets. However, as long as companies are able to grant options with no impact on their income statements, it is unlikely that corporate boards or shareholders will stop granting options. As long as options are freely granted, there is potential for executives to amass enough of them to encourage questionable business decisions, leaving us to possibly face a similar crisis in the future.