

CHANGING SOCIAL NORMS AND CEO PAY: THE ROLE OF NORMS ENTREPRENEURS

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I. INTRODUCTION

Society can and does execute its own mandates: and if it issues wrong mandates instead of right, or any mandates at all in things with which it ought not to meddle, it practices a social tyranny more formidable than many kinds of political oppression Protection, therefore, against the tyranny of the magistrate is not enough: there needs protection also against the tyranny of the prevailing opinion and feeling; against the tendency of society to impose, by other means than civil penalties, its own ideas and practices as rules of conduct on those who dissent from them¹

There is an overwhelming sense of outrage and anger at perceived excesses in CEO

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¹ JOHN STUART MILL, ON LIBERTY AND OTHER ESSAYS 8 (John Gray ed., Oxford Univ. Press 1998) (1926).

compensation ensuring regular coverage in the popular press, and making it, arguably, the most pressing question in current corporate law. There is scarcely a day when institutional shareholders, labor unions, politicians, and small investors are not calling for action to address this alleged menace. Inevitably, the heightened scrutiny and often shrill advocacy has contributed to the apparent disesteem for CEOs, with some polls showing that only seventeen percent of the public expect CEOs to tell the truth, in contrast with twenty-five percent for members of the U.S. Congress.² This state of affairs has fuelled a vigorous debate about the desirability of regulatory intervention to address the problem, with no discernible agreement about the nature and extent of regulation.³ The populist nature of the cause has prompted politicians to enter the fray and recent years have seen activity in Congress⁴ and the SEC.⁵ Parallel to these developments, norms entrepreneurs have been active in creating social norms and enforcing them with social sanctions, with some modicum of success, suggesting that regulatory intervention might be premature until the ramifications of these actions are better understood.⁶ There is some evidence of apparent declines in executive compensation following the secondary enforcement of social norms.⁷ If existing social norms can be leveraged or new norms can be created, the behavioral change necessary for constraining CEO greed might be attained at a lower cost.⁸ This is salient in

² John Maggs, *CEOs Under Fire*, NAT'L J., June 16, 2007, at 42. Maggs notes that “[i]n the late 1990s, corporate execs were among the most revered people in America; people credited their entrepreneurship with helping to drive one of the most prosperous decades in U.S. history.” *Id.*

³ LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* 1-12 (2004); Stephen M. Bainbridge, *Executive Compensation: Who Decides?*, 83 TEX. L. REV. 1615, 1618-19 (2005); Linda J. Barris, *The Overcompensation Problem: A Collective Approach to Controlling Executive Pay*, 68 IND. L.J. 59, 67 (1992); John E. Core et al., *Is U.S. CEO Compensation Inefficient Pay Without Performance?*, 103 MICH. L. REV. 1142 (2005) (reviewing BEBCHUK & FRIED, *supra*).

⁴ See H.R. Res. 301, 110th Cong. (2007) (“providing for consideration of the bill (H.R. 1257) to amend the Securities Exchange Act of 1934 to provide shareholders with an advisory vote on executive compensation”).

⁵ In 2006 the SEC promulgated detailed rules aimed at providing better disclosure to shareholders. See, <http://www.sec.gov/rules/final/2006/33-8765.pdf>

⁶ ROBERT C. ELLICKSON, *ORDER WITHOUT LAW: HOW NEIGHBORS SETTLE DISPUTES* 281-82 (1991). (“For a wide variety of reasons, legal intervention can flop. To avoid the frustration of trying to influence what is beyond their reach, legal instrumentalists would be wise to deepen their understanding of the nonlegal components of the system of social control.”)

⁷ Kaja Whitehouse, *CEO Compensation Survey*, Wall Street Journal, 4/9/2007, R4 (“a recent study shows greater rates of executive turnover at companies where boards were targeted by such (withhold) campaigns, and some firms – including Home Depot, Ryland Group and UnitedHealth Group – changed their pay practices after certain board members suffered sizable withhold votes last year.” See generally Randall S. Thomas & Kenneth J. Martin, *The Effect of Shareholder Proposals on Executive Compensation*, 67 U. CIN. L. REV. 1021 (1999).

⁸ Abigail Barr, *Social Dilemmas and Shame-Based Sanctions: Experimental Results from Rural Zimbabwe* (Ctr. for the Study of Afr. Econ., Working Paper No. 149, 2001), available at <http://www.csae.ox.ac.uk/workingpapers/pdfs/2001-11text.pdf>. (“Individuals who feel external shame respond to anticipated shame-based sanctions just as they respond to anticipated pecuniary sanctions; they choose a level of cooperation that equates the marginal expected loss in utility due to feeling external shame with the marginal loss in utility due to cooperating.”)

corporate law since the experience with legal sanctions has not been particularly satisfactory.⁹ The law might also interact with social norms in salutary ways, a perception that might explain the efforts by norms entrepreneurs and other actors to seek legislative intervention.¹⁰

Despite the high costs imposed by regulatory interventions, corporate law scholarship has only taken a nodding interest in alternative approaches that leverage the power of social norms.¹¹ This is in marked contrast to areas like criminal law which have profited from scholarly exchanges about the role of social sanctions.¹² The lack of scholarly attention is especially galling, because social sanctions have been employed by norms entrepreneurs like labor unions and institutional shareholders for several years.¹³ Norms entrepreneurs have frequently employed social sanctions like shaming prior to seeking more material sanctions like the expulsion of directors from corporate boards.¹⁴ Their ability to deploy social sanctions is enhanced by the alignment of objectives amongst shareholders,¹⁵ and the significant gatekeeping role of epistemic communities.¹⁶ In addition, corporate directors are relatively homogenous, and belong to several

⁹ Renee M. Jones, *Law, Norms, and the Breakdown of the Board: Promoting Accountability in Corporate Governance*, 92 IOWA L. REV. 105, 126 (2006).

¹⁰ See Testimony of Richard Ferlauto of AFCME, http://www.house.gov/apps/list/hearing/financialsvcs_dem/htferlauto030807.pdf.

¹¹ See, e.g., Linda M. Beale, *Putting SEC Heat on Audit Firms and Corporate Tax Shelters: Responding to Tax Risk with Sunshine, Shame and Strict Liability*, 29 J. CORP. L. 219, 222 (2004).

¹² Dan M. Kahan & Eric A. Posner, *Shaming White-Collar Criminals: A Proposal for Reform of the Federal Sentencing Guidelines*, 42 J.L. & ECON. 365, 368-76 (1999); Dan M. Kahan, *What Do Alternative Sanctions Mean?*, 63 U. CHI. L. REV. 591, 593-94 (1996) [hereinafter Kahan, *Alternative Sanctions*]; Dan Markel, *Are Shaming Punishments Beautifully Retributive? Retributivism and the Implications for the Alternative Sanctions Debate*, 54 VAND. L. REV. 2157, 2160-65 (2001); Toni M. Massaro, *Shame, Culture, and American Criminal Law*, 89 MICH. L. REV. 1880, 1882-4 (1991); James Q. Whitman, *What is Wrong with Inflicting Shame Sanctions?*, 107 YALE L.J. 1055, 1056-59, 1087-89 (1998). For a brilliant piece on the role of shame in corporate law, see David A. Skeel, Jr., *Shaming in Corporate Law*, 149 U. PA. L. REV. 1811, 1811-13 (2001).

¹³ Siobhan Hughes & Kaja Whitehouse, *Labor Fights Verizon Board over CEO's Compensation*, WALL ST. J., Apr. 6, 2007, at A3 (quoting AFL-CIO Secretary-Treasurer Richard Trumka as saying, "I defy anybody to say this guy's earned the money" and calling Verizon "the poster child for pay for pulse" (internal quotation marks omitted)). Glass Lewis' labeling of Kenneth Langone, a member of NYSE's board who defended Grasso's pay package as a "chronic overpayer," is another example of shaming. Troy Wolverton, *AFL-CIO's Throw-the-Bum-Out Call Gets Cool Reception*, THE STREET, Sept. 26, 2003, <http://www.thestreet.com/print/story/10116076.html>.

¹⁴ The AFL-CIO called for Kenneth Langone, a director of the NYSE board who defended Richard Grasso's compensation package, to be dropped from the board of GE and four other public companies. See Wolverton, *supra* note 13; Kaja Whitehouse, *CEO Compensation Survey*, Wall Street Journal, 4/9/2007, R4, quoting Joe Grundfest: "Directors are highly sensitive to public criticism . . . a large number of directors don't do it for the money."

¹⁵ Some believe that shareholders are only motivated by the desire to make money. See JOHN R. NOFSINGER, *THE PSYCHOLOGY OF INVESTING* xi (2002) ("An old Wall Street adage states that two factors move the market: fear and greed. Although true, this characterization is far too simplistic. The human mind is very sophisticated, and human emotions are very complex. The emotions of fear and greed just don't adequately describe the psychology that affects people.").

¹⁶ Peter M. Haas, *Introduction: Epistemic Communities and International Policy Coordination*, 46 INT'L ORG. 1, 3 (1992) (defining an epistemic community as a "network of professionals with recognized expertise and competence in a

groups, whether they are other corporate boards, or clubs and other organizations.¹⁷ Such networks are conducive to the deployment of social sanctions because membership benefits are dependent on reputation. Even if the particular director or CEO is shameless, the very process of interaction with others who might experience shame facilitates norm internalization in potential corporate directors.¹⁸

This Article will explore attempts by norm entrepreneurs to create or modify social norms, and their implications for the CEO compensation debate. It argues that the relevant social norms are in a state of flux because of the work of norms entrepreneurs, whose efforts might reduce the need for legislative intervention.¹⁹ Several new norms like majority voting for board election,²⁰ say on pay,²¹ smaller multiples for severance packages,²² and respect for shareholder activists²³ may be emerging due to the work of norms entrepreneurs. This argument draws on social norms scholarship and applies it to the problem of excessive CEO pay in new ways.²⁴ Part II analyzes the rich literature on social norms to determine if there are models capable of

particular domain and an authoritative claim to policy-relevant knowledge within that domain or issue-area”).

¹⁷ Lisa Fairfax, "Some Reflections on the Diversity of Corporate Boards: Women, People of Color, and the Unique Issues Associated with Women of Color". 79 St. John's L. Rev. 1105, 2005 Available at SSRN: <http://ssrn.com/abstract=921037>

¹⁸ See Kahan, *Alternative Sanctions*, *supra* note 12, at 639. Professor Kahan argues that shaming has the effect of shaping preferences. If individuals are shamed for contravening a particular asserted norm, other observers will modify their own behavior to fit that asserted norm.

¹⁹ The CEO of Home Depot responded to a question about the excessiveness of his predecessor Nardelli's pay saying: "It's like tectonic plates are shifting, and human beings get caught between those shifting plates. We are seeing a kind of societal shift in terms of how much shareholders are willing to pay C.E.O.s." Joe Nocera, *Speaking Up In Fresh Air At Home Depot*, 5/26/07 N.Y. Times C1, 2007 WLNR 9883357.

²⁰ Jena McGregor, *Activist Investors Get More Respect*, 6/11/07 Bus. Wk. 34 2007 WLNR 10599687. ("The most widely adopted reform this year has been majority voting. First introduced three years ago, the new rule means directors must be elected by more than 50% of shareholder votes rather than just by a plurality. For meetings so far this year, 57% of the proposals on this topic have been withdrawn after shareholders either negotiated deals or companies agreed to adopt the new rule--up from 25% this time last year."); Kaja Whitehouse, *CEO Compensation Survey*, Wall Street Journal, 4/9/2007, R4 ("At the start of February, 52% of companies in the Standard & Poor's 500-stock index had adopted majority voting, up from 16% a year earlier.")

²¹ *Id.* ("Say on pay" proposals ... were filed at 66 companies this year after first finding their way to the ballot in 2006. Although only two companies, Blockbuster Inc. and Verizon Communications Inc., have seen the idea win more than 50% of votes, many votes came flirted with a majority. The average vote on the issue so far this year is 43%, up from 40% last year.") The article quotes Stephen M. Davis, president of independent governance consulting firm Davis Global Advisors Inc.: "It's taken off like a rocket... To have the first year of a widespread campaign producing votes with 30% to 50% outcomes is unheard of."

²² *Id.* Resolutions requiring shareholder approval for severance packages exceeding 3 times pay received 66% support in 2007, up from 52% in 2006.

²³ *Id.* AFSCME formed a working group to bring together more than 20 companies, unions, and investors to explore ways in which say on pay might be adopted by U.S. companies. The article quotes Richard Ferlauto of AFCME: "Five years ago we would have never gotten in a corporate boardroom... Now we're regularly meeting with corporate directors about substantive issues."

²⁴ That social norms can play an important role in promoting cooperative behavior is well documented. See Ernst Fehr & Simon Gächter, *Cooperation and Punishment in Public Goods Experiments*, 90 AM. ECON. REV. 980, 980, 984 (2000), available at http://www.iew.unizh.ch/chairs/fehr/team/fehr/publications/coop_pun.pdf.

application to better correlate executive compensation with performance. Despite several problems at the definitional level, it argues that the actions of constituencies relevant to the CEO pay debate might be explained by signaling, esteem, and expressive theories. Further, social norms theories neglecting internalization are deficient; corporate actors undertake self-improvement only when they internalize norms. Part III identifies the work of norms entrepreneurs in creating or changing norms pertaining to CEO compensation, and analyzes the reasons for their success. The examples considered demonstrate the effects of dynamic normative transformations on corporate actors and illustrate the contrast in behavioral changes accompanying resistance and acceptance of new norms. Part IV concludes that norm creation in corporate law is facilitated by the role of groups where membership benefits are dependent on reputation; that directors cannot tradeoff reputation like CEOs, making the deployment of reputational sanctions against them powerful; that behavioral change is more effective when there is norm internalization; and that norms entrepreneurs ought to focus on socializing relevant actors if they aspire to be successful in achieving normative change. In doing the above, this Article seeks to make a contribution by opening up new areas for the study of the ways in which social norms change in response to the actions of norms entrepreneurs and suggests options for legislators and regulatory bodies in meeting demands for intervention.

PART II: SOCIAL NORMS

There is a growing body of scholarship analyzing the role of norms in society.²⁵ This fecund literature sheds light on the expressive dimensions of labeling conduct as prosocial or antisocial.²⁶ Tapping into insights from this literature could provide a rich vein of material for the CEO compensation debate because of its emphasis on the role of groups and the participation of actors therein, factors that are very much in play in corporate law. It also suggests alternatives to the regulation versus free-market arguments that plague the debate amongst corporate law scholars.

The norms debate has seemingly been unhindered by the considerable disagreement at the definitional level.²⁷ In the conception of some scholars, “norm” means only decentralized or

²⁵ See, e.g., Lawrence Lessig, *The Regulation of Social Meaning*, 62 U. CHI. L. REV. 943 (1995); Richard H. McAdams, *The Origin, Development, and Regulation of Norms*, 96 MICH. L. REV. 338 (1997); Eric A. Posner, *The Regulation of Groups: The Influence of Legal and Nonlegal Sanctions on Collective Action*, 63 U. CHI. L. REV. 133 (1996); Richard A. Posner, *Social Norms and the Law: An Economic Approach*, 87 AM. ECON. L. REV. 365 (1997); Cass Sunstein, *On the Expressive Function of Law*, 144 U. PA. L. REV. 2021 (1996). Owing to the number of scholars at the University of Chicago doing this work, some have referred to it as the “New Chicago School.” See, e.g., Lawrence Lessig, *The New Chicago School*, 27 J. LEGAL STUD. 661 (1998) [hereinafter Lessig, *The New Chicago School*].

²⁶ See McAdams, *supra* note 25, at 341-42.

²⁷ There have been at least four law review symposia on the topic, and hundreds of articles. See, e.g., Dan Kahan & Lawrence Lessig (eds), Symposium Issue on *Social Norms, Social Meaning, and the Economic Analysis of Law*, 27(2) J. LEGAL STUD. (1998).

informal rules, to the exclusion of organizational rules.²⁸ Other scholars include both organizational and informal rules within the definition of norms.²⁹ There are yet other scholars who treat legal obligations also as norms.³⁰

Some scholars are more functionalist in their approach and approach norms as a way to craft efficient solutions.³¹ Sunstein defines “social norms” as “social attitudes of approval and disapproval, specifying what ought to be done and what ought not to be done. . . . [with regard to] nearly every aspect of human behavior.”³² In a series of brilliant articles on the subject, Richard McAdams defines norms as “informal social regularities that individuals feel obligated to follow because of an internalized sense of duty, because of a fear of external non-legal sanctions, or both.”³³ He distinguishes between a social norm and a convention: the former is a behavioral regularity that is

[s]ustained in part by the fact that individuals generally approve . . . conformity and/or disapprove . . . non-conformity. Norms are, therefore, perceived by individuals in the relevant population as obligatory, a regularity one “ought” to follow, whether or not they are justified in moral theory. . . . [and they are] generally followed by the individuals in a population.³⁴

This “ought” element is the key to an act becoming a norm and transforms it from a “mere aspiration” into conduct requiring obedience. McAdams’s model is predicated on the costs of enforcement being very low; the only requirements for norm enforcement are “simple attitudes of being positively or negatively inclined toward – liking or disliking – the behavior.”³⁵ In contrast, conventions (such as doffing one’s hat at an acquaintance to show respect or recognition) do not implicate any kind of sanctioning behavior.³⁶ This is arguable because the violation of the hat doffing convention can also come at a price; the acquaintance that is subject to one’s failure to doff might retaliate in kind, or in other ways.

In the sanctioning respect, both conventions and norms are similar; the existence or

²⁸ See ELLICKSON, *supra* note 6, at 130-31.

²⁹ See Lisa Bernstein, *Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 J. LEGAL STUD. 115 (1992); McAdams, *supra* note 25, at 351.

³⁰ See McAdams, *supra* note 255, at 340.

³¹ Robert D. Cooter, *Structural Adjudication and the New Law Merchant: A Model of Decentralized Law*, 14 INT’L REV. L. & ECON. 215, 224-26 (1994).

³² Cass R. Sunstein, *Social Norms and Social Roles*, 96 COLUM. L. REV. 903, 914 (1996).

³³ McAdams, *supra* note 255, at 340. McAdams defines it as “a regularity of behavior among a population of individuals, the central feature of which is that most or all of the individuals approve conformity to the regularity and/or disapprove non-conformity.” Richard H. McAdams, *Conventions and Norms: Philosophic Aspects*, in INTERNATIONAL ENCYCLOPEDIA OF THE SOCIAL AND BEHAVIORAL SCIENCES 2735 (Neil J. Smelser & Paul B. Baltes eds., 2001) [hereinafter McAdams, *Conventions*].

³⁴ McAdams, *Conventions*, *supra* note 333, at 2739.

³⁵ *Id.*

³⁶ *Id.*

otherwise of a sanction is not the differentiating characteristic of norms vis-à-vis conventions. What, then, is the difference? Robert Scott writes that conventions are “behavioral regularities that are commonly observed, such as serving dessert after dinner and not before,” whereas norms “are behavioral regularities that create an obligation to obey.”³⁷ This sense of obligation springs “either from an internalized sense of duty, or from a fear of external sanctions such as shaming or shunning, or from both.”³⁸ Scott critiques McAdams’s model on the ground that shaming is not costless as he asserts, arguing that if it were, “then the information the law transmits about the preferences of others . . . no longer has any role to play in the analysis. After all, nothing can lower the cost of something that is already costless.”³⁹ Scott recognizes that “shaming carries both benefits and costs;”⁴⁰ and people engage in a cost-benefit calculus prior to engaging in shaming behavior, acting only if the benefits exceed the costs.⁴¹ He acknowledges the secondary benefits accruing to the enforcer in terms of the effect that enforcement has in conveying to bystanders that the enforcer is a “good type.”⁴² Scott writes that this more nuanced reading means that “the law not only provides information about others’ expected behavior, but it also provides a *justification* for norm enforcers to speak out by affirming the appropriateness of their preexisting preferences.”⁴³

For McAdams, social norms can spring forth informally through familiar negative vehicles such as censure, ostracism, gossip, and violence, just as equally as through positive ones like praise and material incentives.⁴⁴ McAdams acknowledges the internal element to social norms: the existence of feelings like pride and guilt that accompany normative behavior.⁴⁵ His esteem model is predicated on people having the ability to make “evaluative options” about others.⁴⁶ It is sufficient that people direct opinions at the behavior of others and that the opinions are shared by members of the public.⁴⁷ Unlike other scholars, McAdams does not require agreement from a majority of the population for the constitution of a norm.⁴⁸ Norm creation takes place through “selfish esteem allocation,” “group discussion,” and “exit.”⁴⁹ If the particular

³⁷ Robert E. Scott, *The Limits of Behavioral Theories of Law and Social Norms*, 86 VA. L. REV. 1603, 1610 (2000). Scott conceded that “the distinction between conventions and norms is fuzzy. Often conventions, such as table manners, become normative over time in the sense that deviation is subject to social sanctions and, in turn, creates a felt obligation to obey.” *Id.* at 1610 n.15.

³⁸ *Id.*

³⁹ *Id.* at 1617 n.28.1611.

⁴⁰ *Id.*

⁴¹ *Id.*

⁴² *Id.*

⁴³ *Id.*

⁴⁴ McAdams, *Conventions*, *supra* note 333, at 2739.

⁴⁵ See McAdams, *supra* note 25, at 407-08.

⁴⁶ *Id.* at 358.

⁴⁷ *Id.*

⁴⁸ *Id.*

⁴⁹ *Id.* at 360.

behavior is commendable and its absence deplorable, a norm will emerge.⁵⁰ There must be substantial agreement, and common knowledge as to this fact.⁵¹ In this scenario, the esteem cost is the “probability that a violation of the consensus will be detected multiplied by the value of the esteem that would then be lost.”⁵² Upon the identification of the esteem cost, an esteem-based norm emerges obligating persons to engage in the particular behavior when, for most people, “this esteem cost exceeds the cost of following the consensus.”⁵³

It is true that inflicting any kind of sanction is costly.⁵⁴ Even in the McAdams esteem model,⁵⁵ the very act of withholding esteem is not as costless as he suggests. The enforcer is not free from costs just because he only withholds esteem. Even if the sanction is relatively passive, such as shunning or avoiding the wrongdoer, there is still a price that has to be paid.⁵⁶ This may be awkwardness experienced when the enforcer unintentionally comes into contact with the offender or a direct confrontation by the offender demanding to know why the enforcer is avoiding him. Regardless of what form the cost takes, there is little doubt that it exists, measured by the enforcer’s position post-sanction relative to his position pre-sanction.

In many instances, this cost is only borne by the enforcer, despite the benefit being shared by the non-participating bystander.⁵⁷ To be sure, benefits of a secondary nature may accrue to the enforcer; these include the conveyance of an appearance of courage, integrity, and willingness to enforce the norm - all adding up to show that the enforcer is a good type. Some enforcers are

⁵⁰ *Id.* at 358. (“[T]he desire for esteem produces a norm. For some behavior *X* in some population of individuals, a norm may arise if (1) there is a consensus about the positive or negative esteem worthiness of engaging in *X* (that is, either most individuals in the relevant population grant, or most withhold, esteem from those who engage in *X*); (2) there is some risk that others will detect whether one engages in *X*; and (3) the existence of this consensus and risk of detection is well-known within the relevant population.”)

⁵¹ *Id.* at 358-65. (“When these conditions exist, the desire for esteem necessarily creates costs of or benefits from engaging in *X*. If the consensus is that *X* deserves esteem, a norm will arise if the esteem benefits exceed, for most people, the costs of engaging in *X*.”).

⁵² *Id.* at 364.

⁵³ *Id.*

⁵⁴ See RICHARD A. POSNER, *THE ECONOMICS OF JUSTICE* 211-12 (1981); Doron Teichman, *Sex, Shame, and the Law: An Economic Perspective on Megan’s Laws*, 42 HARV. J. ON LEGIS. 355, 363 (2005) (contending that “[i]n the context of SORNs, for example, these costs include setting up notification websites, updating these websites, tracking down offenders, and actively notifying communities”). Teichman asserts that “Non-legal sanctions are unique because through their use, the government can externalize some of the costs of sanctioning to the public.” *Id.* at 364 n.38.

⁵⁵ See McAdams, *Conventions*, *supra* note 333, at 2739. The esteem model has traction in the CEO compensation context because people with high self-esteem are more likely to respond to the withholding of esteem. See Jones, *supra* note 9, at 144.

⁵⁶ See, e.g., Julia A. Houston, Note, *Sex Offender Registration Acts: An Added Dimension to the War on Crime*, 28 GA. L. REV. 729, 732-33 (1994) (pointing out problems of implementing SORNs associated with their costs); Denise M. Bonilla & Joy L. Woodson, *Continuing Debate Over Megan’s Law*, L.A. TIMES, Feb. 14, 2003, at B2 (California Attorney General pointing out that verifying registration would cost the state \$15 million to \$20 million which is a “hefty request” given the California budget deficit).

⁵⁷ McAdams, *supra* note 255, at 352-53.

“shame-centered,”⁵⁸ and do not interact with those who are shamed. By showing that he is a good type, in some circumstances the enforcer could also be trying to stave off a sanction against passivity that other enforcers might impose.⁵⁹ This sanction might take the form of the passive person being labeled a coward, being shunned as lacking a strong moral core, and so on. There are instances of people who do not participate in consumer boycotts being punished in various ways, apparently exemplifying that passivity may not always be costless.⁶⁰ This secondary sanctioning is often under-analyzed by legal scholars who write about shaming. In the absence of effective secondary shaming, the free-rider problem becomes a serious obstacle to the effective deployment of shame sanctions.⁶¹

1. Signaling Model

Eric Posner proposed a model of social norms suggesting they are a communication or “signaling” device enabling reliable transaction partners to find each other and enter into cooperative transactions.⁶² For Posner, the “discount rate” that individuals possess is the most

⁵⁸ Alon Harel & Alon Klement, *The Economics of Shame: Why More Shaming May Deter Less* 5 (Aug. 24, 2005) (unpublished working paper, on file at <http://ssrn.com/abstract=789244>) (“They do not care whether the individuals they interact with are offenders or not. They are, however, reluctant to interact with shamed individuals. Such reluctance may be attributed to the unwillingness to be publicly observed interacting with shamed individuals. Interaction with the shamed might signal to third parties that those interacting with them are also ‘bad types.’”).

⁵⁹ This is the idea behind the signaling theory postulated by Eric Posner, whereby people are either “cooperators” who have a low discount rate, or “cheaters” who have a high discount rate. See Eric A. Posner, *Symbols, Signals, and Social Norms in Politics and the Law*, 27 J. LEGAL STUD. 765, 767-72 (1998). Cooperators and cheaters all play repeated games in which the former maximize their payoffs by interacting among themselves. *Id.* To exclude cheaters, cooperators can use costly signals that only individuals who expect the high, long-term cooperative payoff can afford to send. *Id.* at 768-69. The cost incurred by the sanctioning party is exactly what makes the infliction of the non-legal sanction a credible signal. *Id.* at 768. People who are passive are seen to be non-cooperators and are excluded from profitable interactions with cooperators. See *id.* at 770.

⁶⁰ MONROE FRIEDMAN, *CONSUMER BOYCOTTS: EFFECTING CHANGE THROUGH THE MARKETPLACE AND THE MEDIA* 136 (1999) (describing how the Jewish boycott against German goods during World War II was rigorously enforced by non-legal sanctions); William Muraskin, *The Harlem Boycott of 1934: Black Nationalism and the Rise of Labor-Union Consciousness*, 13 LAB. HIST. 361, 364 (1972) (presenting a case in which the photographs of boycott violators were published in a local newspaper); Sankar Sen et al., *Withholding Consumption: A Social Dilemma Perspective on Consumer Boycotts*, 28 J. CONSUMER RES. 399, 401 (2001) (pointing out the connection between consumer boycotts and group membership).

⁶¹ Laurent Denant-Boemont et al., *Punishment, Counterpunishment and Sanction Enforcement in a Social Dilemma Experiment 3* (Aug. 2005) (unpublished paper, on file with Emory University), available at <http://userwww.service.emory.edu/~cnoussa/Punishment%20August%202005.pdf> (“Because individuals who administer sanctions bear the cost of doing so, while all players benefit from the resulting increase in contributions, there is an incentive for individuals to free ride on others’ provision of sanctions against low contributors.”).

⁶² See ERIC A. POSNER, *LAW AND SOCIAL NORMS* 18-29 (2000). Posner’s account is based on the standard prisoner’s dilemma where each prisoner has a “dominant” strategy of defection. Faced with the lack of knowledge about whether the other prisoner will confess, each prisoner does better by confessing no matter what the other prisoner does. If, however, the game is repeated, depending on how much the future is valued, cooperative outcomes may emerge. Defection is no longer the dominant strategy because of the possibility that such behavior will induce the other prisoner to defect in the

valuable piece of information in making decisions about their suitability for entering into cooperative relationships.⁶³ Some individuals are willing, as a matter of disposition, to incur short-term losses in pursuit of longer-term cooperative gains;⁶⁴ these individuals are “good types.”⁶⁵ In contrast, other individuals are disposed to defect from cooperative endeavors whenever they can obtain short-term benefits from defection-oriented strategic actions;⁶⁶ such individuals are “bad types.”⁶⁷ In the marketplace for cooperative transactions, it is in the interest of good types to reveal their low discount rate to potential transacting parties, by acting in ways that reveal their dispositions.⁶⁸ Similarly, it is also in the interest of bad types to seek cooperative interactions with good types because of the obvious payoffs from such interactions.⁶⁹ Thus, all actors have an interest in signaling a low discount rate if they wish to engage in cooperative transactions.⁷⁰ However, for this to work effectively, it must not be possible for everyone to send such signals.⁷¹

As Posner writes, “[s]ignals reveal type if only the good types, and not the bad types, can afford to send them, and everyone knows this.”⁷² Signals are distinguished from non-signals by norms entrepreneurs, who function as the arbiters. It is unclear as to what process is used, how norms entrepreneurs choose behaviors qualifying as signals, and what causes others to accept this characterization. In the absence of a satisfactory explanation, it seems to fall into the territory of taste, which Posner expressly excludes in his model.

Posner contends that manners and fashion – the way one holds a fork, for example – are signals of one’s discount rate.⁷³ His argument is only true in very small groups that share certain common attributes.⁷⁴ If one were to dine at Oxford, for example, one would only pass the Port to the left. Such a rule would be completely unknown in the United States, as this author can attest from experience.⁷⁵ Signals of this nature cannot work in modern diverse societies, and Posner exaggerates their value in the evaluative process leading to the determination about whether an individual is a “good type,” or is a suitable cooperative partner. To be sure, Posner might respond that passing Port to the left is a signal at an Oxford college table. Observers might believe, *inter alia*, that one who passes Port to the right comes from a lower class, has no manners, is poor,

future rounds. Cooperation, on the other hand, might induce cooperation from the other prisoner’s side.

⁶³ *Id.* at 18.

⁶⁴ *Id.* at 19-21.

⁶⁵ *Id.* at 18.

⁶⁶ *Id.*

⁶⁷ *See id.* at 18-20.

⁶⁸ *Id.* at 20-21.

⁶⁹ *Id.* at 19.

⁷⁰ *Id.*

⁷¹ *Id.*

⁷² *Id.* at 19; *see also* Posner, *supra* note 59, at 772 (“As long as an action is both actually and apparently costly, it can serve as a signal that the sender belongs to the high type. As noted above, gift giving, advertising, the purchase of fashions, and other forms of conspicuous consumption can serve as signals in the cooperation game.”).

⁷³ POSNER, *supra* note 62, at 22.

⁷⁴ *Id.*

⁷⁵ *Id.* at 23. Many a dinner has been marred by waiting for the Port to make its way to one’s glass!

absentminded, careless, or contemptuous of social rules. While these are plausible conclusions based on the behavior, they may not affect that person's ability to enter into cooperative relationships in any meaningful sense because of the multi-layered nature of the partner selection process. It is very conceivable that these conclusions about a person, based on passing the Port in the wrong direction, actually make him a more attractive cooperation partner, albeit for different reasons.

For Posner, norms do not cause behavior. He argues that “[t]he claim that a social norm caused *X* or *Y* is an empty claim. The appropriate claim is ‘individuals seeking *a* or *b* interacted in such a way as to produce behavioral regularities *X* or *Y*, regularities that we call ‘social norms.’”⁷⁶ The secondary enforcement of norms by social sanctions such as shaming are also calculated to show a low discount rate.⁷⁷

Posner's conception of norms is critiqued by Richard McAdams, expressing doubt about his definition of norms.⁷⁸ He writes that “[t]he behavioral regularities that Posner describes, which arise from ‘partial information – either about the value of some activity or about the character of people who engage in it’ – might be considered a custom or convention or something else, but ‘norm’ seems an odd term if the inhabitants of the theory have no normative commitments or beliefs that contribute to the regularity.”⁷⁹ Posner's theory also suffers because he dispenses with the need for internalization on the grounds that there are no satisfactory theories to explain “what kinds of people feel guilt and what kinds of people do not.”⁸⁰ That we do not understand the process of internalization is not a sufficient reason to ignore the need for internalization in the creation of norms.

Posner's “commitment model,”⁸¹ also does not work because the example that he uses – teenagers defying social conventions – is a fundamental mischaracterization. It strains logic to believe that teenagers act in ways that violate conventional rules because they seek future payoffs from other teenagers by cutting off opportunities with the mainstream adult population. In fact, frequently this result would not be achieved at all even if the mythical teenager that Posner is imagining existed. Almost every teenage act of rebellion is heavily discounted by the adult population as stemming from misdirected energies or immaturity, and there is very little shrinkage in opportunities for cooperative relationships with adults as a result. Most adults

⁷⁶ *Id.* at 88-90.

⁷⁷ *Id.* at 89-90.

⁷⁸ See Richard H. McAdams, *Signaling Discount Rates: Law, Norms, and Economic Methodology*, 110 YALE L.J. 625, 679 (2001) (“The sparseness of the model is so profound that it raises the terminological question of whether the behavioral regularities that Posner addresses are even norms. The term ‘norm’ is usually used to refer to a behavioral regularity accompanied by some kind of normative motivation, the least of which are approval (moral or otherwise) of conformity to the regularity and disapproval of nonconformity.”).

⁷⁹ *Id.* (citation omitted).

⁸⁰ POSNER, *supra* note 62, at 43 (“So if we observe . . . that some people litter but others do not, we cannot rely on a theory of guilt for an explanation.”).

⁸¹ *Id.* at 29. A commitment model is distinguished from the signaling model and explains that people demonstrate “loyalty” to a deviant or fringe group “by ostentatiously violating the norms of a dominant group.” *Id.* at 28-29.

forgive teenage infractions, and all but the naivest teenager is able to perceive this. It is this knowledge, that all will be forgiven, that might prompt many kinds of rebellious behavior. Thus, many actions by teenagers to act in unconventional ways like having tattoos or piercings have very little impact on the availability of adult partners to transact with, if at all they desire such transactional opportunities. Therefore, there is very little signaling benefit to teenage unconventional behavior in the Posnerian sense.⁸² To be sure, there are likely to be some adults who might be less forgiving, but this group of adults is probably also a fringe or deviant group in some sense.

Despite its limitations, applying Posner's signaling model to the CEO compensation problem offers interesting insights. Directors might attempt to pay CEOs just enough to attract the best candidate and ensure optimum performance in order to signal to others their low discount rate and their suitability as candidates for retention on the board and for other board appointments. For this to work, norms entrepreneurs should be able to define what constitutes an appropriate signal – in other words, the kinds of actions that boards must undertake to show they are not overpaying CEOs. Mere statements about shareholder welfare cannot serve as signals because they are so cheap as to allow any boardmember to send them. Their actions have to be costly enough for observers to separate them from cheap talk. The example of Blockbuster's board negotiating down departing CEO Antioco's bonus and severance package, discussed in Part III, might be illustrative of such signaling. The cost of signaling was the risk of Mr. Antioco suing and the possibility that potential replacements would decline the job. Signaling might also explain institutional shareholders and labor unions making precatory proposals at annual meetings – they are demonstrating low discount rates by engaging in sanctioning behavior. In these examples, directors and shareholder activists are not acting out of a belief that a norm has been violated; rather, their attempts at signaling a low discount rate might result in the emergence of a norm. Posner's commitment model might also explain the actions of investors who shun "sin stocks," at some cost to themselves.

2. Social Meaning and Expressive Law

Lawrence Lessig's work posits that that the social meaning of particular behaviors can vary depending on temporal and cultural factors.⁸³ When a particular behavior runs out of favor in the public consciousness, it can persist because of the collective action problem that individual actions alone cannot solve.⁸⁴ In such circumstances, the state steps in with legal instruments to

⁸² To the extent that there is signaling, this might be attributable to internal deficiencies of self-esteem and like emotions rather than to conscious attempts at constraining transactional opportunities. Teenage rebellious behavior is attributable to assuaging these emotions, and any signaling is inadvertent.

⁸³ See Lessig, *supra* note 255, at 964-72. Lessig gives the examples of the effects of state propaganda on the social meaning of helmets for motorcyclists in Russia, the meaning of the duel for the educated elite in the American South and its relevance to the choice of effective regulation, and the effects of the Civil Rights Act of 1964 on the social meaning of racial discrimination in the South. *Id.*; see also Sunstein, *supra* note 255, at 2025-29; Sunstein, *supra* note 32, at 953-65.

⁸⁴ Lessig, *supra* note 255, at 993-1016.

change the social meaning of behavior.⁸⁵ Lessig differentiates social meaning from social norms, stating that social norms owe their ability to influence conduct “not from something physical or behavioral” but from something that is “interpretive.”⁸⁶ Lessig emphasizes the need to understand “social meaning,” by which is meant the construction that an interpretive community gives to a particular act.⁸⁷ Studies have demonstrated the positive correlation that legal intervention can have on prosocial behavior.⁸⁸ Attaching a legal sanction to behavior can serve to engender displeasure and social condemnation. This works by entitling people to impose their own forms of sanctions against offenders, conveying to potential offenders, that, aside from the legal sanctions, these social sanctions can also be expected to be imposed. The principal example for this idea is the broken windows theory whereby fixing broken windows has a positive effect on crime rates by showing potential offenders that the neighborhood is unlikely to tolerate untidiness, much less criminal behavior.⁸⁹ Similarly, antismoking measures work mostly in the face of negligible enforcement – the law relies on decentralized and privatized empowerment for its teeth.⁹⁰

McAdams has also written about the ability of the state to modify behavior by promulgating law to reveal a latent or imperfectly perceived consensus that existed prior to the passage of the law.⁹¹ Legislation catalyzes behavioral change by sanctioning deviations at the group level.⁹² The signaling effect of the law ensures that individuals cannot act without the risk of incurring the disapproval of other members because that individual is “ignorant of the consensus, or incorrectly believes there is no risk of detection.”⁹³ If the ignorance of the consensus is pervasive, a norm cannot be produced.⁹⁴

Cass Sunstein also focuses on the expressive effects of the law. He writes that statutes such as those targeting littering work even without direct sanctions because people internalize the law’s message, and others understand the possibility of being socially ostracized.⁹⁵ The law only works because the social meaning of littering has been altered from the previously perceived

⁸⁵ See *id.* at 966.

⁸⁶ Lessig, *The New Chicago School*, *supra* note 255, at 680.

⁸⁷ *Id.* at 681.

⁸⁸ Kahan, *supra* note 122, at 639.

⁸⁹ George L. Kelling and James Q. Wilson, The Police and Neighborhood Safety, *The Atlantic Monthly*, March 1982, available at <http://www.theatlantic.com/doc/198203/broken-windows>.

⁹⁰ Robert Cooter has written that though laws against smoking in public are almost never enforced, compliance is widespread suggesting that labeling the behavior as a crime will heighten potential violators’ fear of social sanction, and might also encourage a real increase in social sanctions against violators. See Robert Cooter, *Expressive Law and Economics*, 27 *J. LEGAL STUD.* 585, 594-95 (1998); see also Robert Cooter, *Do Good Laws Make Good Citizens? An Economic Analysis of Internalized Norms*, 86 *VA. L. REV.* 1577, 1590 (2000).

⁹¹ See McAdams, *supra* note 255, at 362.

⁹² *Id.* at 362-64.

⁹³ *Id.* at 362.

⁹⁴ *Id.*

⁹⁵ See generally Cass Sunstein, *Deliberative Trouble? Why Groups Go to Extremes*, 110 *YALE L.J.* 71 (2000).

exercise of freedom to a display of disrespect for others.⁹⁶ A “norm cascade” can be catalyzed in this manner by altering the preferences and behavior of some subset of society.⁹⁷ Thereafter, by the efflux of time, the behavior reaches a tipping point and a new norm takes root.⁹⁸

Expressive theories have explanatory power in the CEO compensation arena. The law can change the social meaning of compensation in several ways including: by signaling that pay unrelated to performance is undesirable or wrong, by fixing mandatory multiples, by removing status benefits from high compensation, and by high taxes. This is at the root of recent legislative efforts like the Say on Pay Bill passed by the House, and the SEC compensation disclosure rules.

3. *The Need for Norm Internalization*

Social norms are enforced by social sanctions, with effectiveness depending on internalization of the norm by the offender.⁹⁹ As a result of such internalization, the offender must believe that his conduct has lowered his reputation either in his own eyes or in the eyes of people whose opinion he cares about.¹⁰⁰ In the absence of this internal aspect, it is hard to distinguish the shame that might flow from a violation of the norm from mere tarnishment of reputation. While negative impacts on reputation can be suffered even when the offender does not believe that he has committed a wrong, he can only experience shame if the alleged wrong accords with norms that have been internalized and is discovered. Rather than feeling some semblance of remorse, if the offender were to become angry after being punished, it is very likely that the reaction will be an impulse to retaliate against those enforcing the sanction.¹⁰¹ Confronted with retaliation, the enforcers, in turn, might become angry and engage in a fresh round of punishment.¹⁰² Thus, multiple rounds of sanctioning behavior can stem from anger at

⁹⁶ *See id.* at 77-81.

⁹⁷ *Id.* at 77.

⁹⁸ *Id.*

⁹⁹ Internalization makes the offender follow the norm regardless of its enforcement. *See* Robert Cooter, *Models of Morality in Law and Economics: Self-Control and Self-Improvement for the “Bad Man” of Holmes*, 78 B.U. L. REV. 903, 910 (1998); Melvin A. Eisenberg, *Corporate Law and Social Norms*, 99 COLUM. L. REV. 1253, 1269-79 (1999).

¹⁰⁰ Jeffrie G. Murphy, *Shame Creeps Through Guilt and Feels Like Retribution*, 18 LAW & PHIL. 327, 340 (1999).

¹⁰¹ *See* Astrid Hopfensitz & Ernesto Reuben, *The Importance of Emotions for the Effectiveness of Social Punishment* 16 (Tinbergen Inst., Discussion Paper No. 05-075/1, 2005), available at <http://www1.fee.uva.nl/creed/pdf/HR05.pdf> (“The effect of anger becomes obvious once we examine the interaction of anger and shame. . . . second movers who were angry and felt no shame retaliate more and more frequently than second movers who were angry and felt shame . . .”).

¹⁰² *See id.* at 2 (“[W]e find that many individuals punish back after being punished. In various cases this escalates as individuals punish each other in turns, resulting in considerable welfare losses.”); *see also* Nikos S. Nikiforakis, *Punishment and Counter-Punishment in Public Good Games: Can We Still Govern Ourselves?* (J. Econ. Literature, Working Paper No. C92, D70, H41, 2005), available at <http://ssrn.com/abstract=764185>. Nikiforakis’ experiment allowed two rounds of sanctions. *Id.* at 3-4. After the first round of sanctions, each participant knows the quantity of punishment points that each individual assigned to him. *Id.* at 3. The second round allows him to sanction those who sanctioned him. *Id.* at 4. This round of sanctioning is truly retaliatory, and is not a case of punishing those who did not

the primary sanction, leading to potentially debilitating social effects.¹⁰³ If, on the other hand, the offender were to experience a sense of remorse, and internalize the sanction, she is less likely to feel anger. This will prevent anger-induced rounds of sanctioning behavior and will make the punishment effective.¹⁰⁴ Studies have shown that shame and guilt can prevent angry responses to punishment, supporting the need for internalization.¹⁰⁵

This presents interesting insights for sanctioning excessive CEO pay. If directors approving a compensation agreement do not believe that it is excessive, they are likely to be angered by the imposition of sanctions against them. It is only when they accept that the agreement is not in the interests of shareholders will shaming work because it will touch the internal element and motivate them to act differently in the future. If they modify their behavior without accepting the excessiveness of the compensation agreement, it is because rational actors comprehend the disutility created by the enforcement actions undertaken by norms enforcers. Ergo, they might be angered by the sanction, and believe it was undeserved, but nevertheless modify their behavior to avoid costs. This will not result in normative change and the change in behavior might be temporary.

Internalization is essential in order for social sanctions to work - this provides the moral compass for self evaluation. In the absence of this internal element, the offender would be able to categorize the reactions of sanction enforcers as being motivated by ill will, malice, envy, jealousy, or some other emotion. After such categorization, it would be relatively easy to be unaffected by the sanction. If other people share this categorization, or can be persuaded to believe that no wrong has been committed, these attempts at sanctioning would have little or no power. Thus, the most important element in ensuring the successful enforcement of sanctions is the offender's internalization of the norm. Social norms can be enforced if there is no detected violation (through the invocation of guilt), and if there is no enforcer, but not if the offender has not internalized the norm.¹⁰⁶

Some scholars like Richard Posner focus mainly on the external dimension.¹⁰⁷ Although

adequately sanction free riders. *Id.*

¹⁰³ Hopfensitz & Reuben, *supra* note 101, at 15 (“First movers who punish do so because they are angry. High intensities of anger are triggered by opportunistic behavior by the second mover, especially if it is unexpected and considered unfair. Retaliation by second movers also makes first movers angry and leads to additional punishment.” (emphasis omitted)).

¹⁰⁴ *Id.* at 17 (“[O]ur results suggest that high intensities of anger provide second movers with a motivation to retaliate and high intensities of shame restrain them from doing so. Furthermore, shame seems to be necessary for punishment to have an effect on how second movers adjust their behavior.”).

¹⁰⁵ *Id.* at 15 (“[S]econd movers who felt no shame are more likely to retaliate than other second movers. ... for second movers who were punished, experiencing shame induces them to correct their behavior.”).

¹⁰⁶ This is recognized by Robert Ellickson, who writes that internalization is brought about by the process of socialization “which an individual then enforces on himself by means of self-administered feelings of guilt and pride.” Robert C. Ellickson, *Law and Economics Discovers Social Norms*, 27 J. LEGAL STUD. 537, 540 (1998).

¹⁰⁷ Richard A. Posner & Eric B. Rasmusen, *Creating and Enforcing Norms with Special Reference to Sanctions*, 19 INT’L REV. L. & ECON. 369, 371 (1999).

[W]e shall treat humiliation as a form of shame, and shame itself as (1) a purely external sanction for (2) violations of the moral code. It is important to note, however, that even when viewed purely as an external sanction, that is, as the product of the actions or reactions of other people, shame (like guilt) is felt even if

he recognizes that shaming has two dimensions, he seems to frequently focus only on the second dimension, suggesting that one can experience shame even without violating an internalized norm.¹⁰⁸ His examples are humiliation rather than shame. It is possible that directors could feel a sense of humiliation because norms entrepreneurs publicize a compensation agreement that exemplifies CEO greed at its worst, even though they themselves have no internalized norm against excessive greed. This will not generate a norm.

Cooter offers a richer model emphasizing the internalization element, writing that people make a moral commitment when they internalize a social norm.¹⁰⁹ He suggests that a social norm is conduct society consensually says people ought to engage in.¹¹⁰ Agreement about what people ought to do is indicative of a possible social norm, but disagreement might be suggestive of a struggle to establish a social norm.¹¹¹ However, this is not a sufficient condition for the establishment of a social norm. Cooter's formulation requires that the social norm be an "effective consensus obligation": people must not only agree that a social norm exists, but must act in accordance with that norm.¹¹² Further, "a social norm is ineffective in a community and does not exist unless people internalize it."¹¹³ A satisfactory explanation for the process of internalization is lacking. Cooter seems content to require a "[u]nanimous endorsement" which has the effect of "convinc[ing] some members of the community to internalize the obligation, and to inculcate it in the young."¹¹⁴ This unanimity will occur when conditions necessitate one signal.¹¹⁵

other people take no action.

Id.

¹⁰⁸ See Posner & Rasmusen, *supra* note 10707, at 371.

One can also be shamed (though the better word here would be "humiliated") for conduct that violates a moral code not one's own and so there is no question of guilt. During the Cultural Revolution in China, people paraded through the streets in dunce caps felt humiliated even if they disapproved of the regime and therefore felt no guilt at violating its norms.

Id.

¹⁰⁹ See Cooter, *supra* note 90**Error! Bookmark not defined.**, at 586. "Internalizing a social norm is a moral commitment that attaches a psychological penalty to a forbidden act. A rational person internalizes a norm when commitment conveys an advantage relative to the original preferences and the changed preferences." *Id.*

¹¹⁰ *Id.* Ellickson defines norms as rules of behavior that are not enforced primarily by courts, but rather by other forces. See Ellickson, *supra* note 120, at 5. For Posner & Rasmusen:

A norm is a social rule that does not depend on government for either promulgation or enforcement. Examples range from table manners and the rules of grammar to country club regulations and standard business practice. Norms may be independent of laws, as in the examples just given, or may overlap them; there are norms against stealing and lying, but also laws against these behaviors.

Posner and Rasmusen, *supra* note 107, at 369.

¹¹¹ Cooter, *supra* note 90, at 587.

¹¹² *Id.* (emphasis omitted).

¹¹³ Robert D. Cooter, *Decentralized Law for a Complex Economy: The Structural Approach to Adjudicating the New Law Merchant*, 144 U. Pa. L. Rev. 1643, 1665 (1996).

¹¹⁴ Cooter, *supra* note 31, at 224.

¹¹⁵ See Cooter, *supra* note 13 *Decentralized Law*, at 1666; Robert D. Cooter, *Law and Unified Social Theory*, 22 J.L. & Soc'y.Socy. 50, 64 (1995).

McAdams disputes the need for internalization, suggesting that the expenditure of time necessary for internalization is unnecessary for the emergence of norms. He argues that both internalization and noninternalization can produce norms – the difference is that in the former case “there is yet another cost to violating a norm: guilt.”¹¹⁶ Norms precede internalization, a formulation that is troubling because it does not explain the effect of withholding esteem on persons who have no internalized norm against the behavior that is being sanctioned.¹¹⁷ In his model, even without internalization, “there will be an esteem cost to acting contrary to a consensus as soon as it, and the inherent risk of detection, becomes well-known. If, for most people, the cost is higher than the benefit of acting against the consensus, a norm will quickly emerge.”¹¹⁸ He seems to be implying that shaming and similar external sanctions produce internalization.¹¹⁹

McAdams seems to have it backwards: people are unlikely to be concerned about disesteem when they believe that they are in the right. Others might disagree with them, but this will not result in behavioral change unless the offender has internalized the norm and feels shame. If others withhold esteem when the person has not internalized the norm, the likely response is anger and defiance.¹²⁰ This will not produce norms.¹²¹ McAdams frequently implies the need for internalization, but never acknowledges its necessity for his model, despite correctly accepting that the mere “[p]ublicizing [of] a consensus will not, by itself, cause individuals to feel guilt from violating the law.”¹²² Yet, he claims (without explaining the origin of the abstract internalized norm) that “[i]f the law publicizes a consensus that certain behavior is required in order to comply with an abstract internalized norm, then violating the concrete (legal and esteem-based) obligation will produce guilt.”¹²³ In the absence of internalization, mere publication of a law will not induce normative behavior, except in cases involving coordination-type problems. These are not in any event, explained by his esteem theory. For example, if the law publicizes a requirement that people drive on the right, it could result in behavior that follows the rule, if backed up by fines. People have no internalized norm at this point, nor are they driving on the right because they believe that there will be disesteem if they drive on the left. If the law is

¹¹⁶ *Id.*

¹¹⁷ *Id.* (“Internalization can occur as the first step in norm production, but I suggest that it frequently follows the creation of the norm by esteem processes.”).

¹¹⁸ Richard McAdams, *supra* note 255, *The Origin, Development, and Regulation of Norms*, 96 Mich. L. Rev. 338, 381. (1997).

¹¹⁹ *Id.* (“This ordering --- shame before guilt --- conforms with those psychological theories that imagine that shaming and disapproval --external sanctions --are precisely what produce internalization.”).

¹²⁰ *Id.* at 382-86.

¹²¹ *Id.* at 385 (“Thus, while guilt arises only from violating an obligation one has internalized, when the obligation is vaguely defined, what counts as a violation may depend on what others think is a violation. The result is that esteem-based norms matter even more; though esteem is an external sanction, esteem-based expectations can invoke internal sanctions.”).

¹²² *Id.* at 407.

¹²³ *Id.*

changed the next day and people are asked to drive on the left, once again, there will be a behavioral change, if backed up by fines.

These kinds of behavioral changes are not very sticky because there is no element of internalization, regardless of the passage of time. Something deeper than legal promulgation is usually needed for people to internalize norms. The role of influential individuals or groups in socializing or selling the norm is the missing link. The success or failure of socialization or norm-selling depends on the value of the individual or group to the target of the action. When parents are selling a norm to their children, the chances of successful reception are especially high when the children are young and dependent on the parents. Conversely, when the children have moved out of the family home, it is harder for parents to be successful.

This analogy can be usefully transposed to the corporate context. Influential institutional shareholders are more likely to succeed in persuading the board of directors to internalize a norm depending on factors such as the size and length of time of their share ownership, ability to move the market, capacity to mount a proxy contest, and prior record in proxy contests. In contrast, an individual who holds just a few shares is less likely to be successful. In the former case, the institutional shareholder is valuable for the board's survival, much like parents for small children. This value is a key determinant in the norm internalization process.

The consequences of internalization for cooperative and noncooperative settings might differ with internalization being beneficial in the former.¹²⁴ It is precisely this scenario that we encounter with CEO compensation. If CEOs engage in structuring their compensation agreements purely with a view to get as much money as possible regardless of their performance and length of service, it is inevitable that shareholders and regulators will focus on monitoring both their compensation agreements and their subsequent performance with greater vigor. This will divert resources away from more productive uses, and while both shareholders and CEOs will have to bear this cost, it is probable that CEOs bear the brunt of these costs. The large number of shareholders brings down individual costs for each shareholder. Several egregious compensation agreements will be unraveled by the increased scrutiny. Thus, while the brilliant CEO will still command a high compensation package, mediocre and egregiously bad CEOs will suffer heavily because of this increased monitoring. Given this reality, all CEOs would be better off by internalizing a social norm against excessive compensation.

The nub of Cooter's argument is that positive law can influence rational actors to change

¹²⁴ See Cooter, *supra* note 90, at 587. He writes:

In a noncooperative setting, moral restraint is a disadvantage, rather like fighting with one hand tied behind your back. In cooperation ventures, however, moral restraint can increase productivity, so people with good character may enjoy an advantage over people with bad character. For example, agents who faithfully serve their principals increase the productivity of principal-agent relationships by reducing monitoring costs.

Id. McAdams also stresses that people obey internalized norms even when they would suffer no adverse consequences if they disobeyed them. See McAdams, *supra* note 25, at 380-81.

their character by facilitating internalization.¹²⁵ Ergo, if a law sanctions CEO greed, it is likely that CEOs would be influenced to be less greedy. This is a costly solution, and shaming might be a cheaper alternative.¹²⁶ If the ability to publicize egregiously high CEO pay exists, it is likely that CEOs will be influenced to be less greedy to avoid condemnation for greed. Abstinence signals to shareholders that they can be relied upon to manage the company's assets in a manner most beneficial to the owners of those assets. Excessive CEO pay, on the other hand, signals to the shareholders that they are not good participants in cooperative settings and that they are not good managers of the shareholders' assets. This works more effectively if the agreements are made public prior to being signed, as the signaling has consequence only before the CEO is hired, because in many cases the CEO may not be in the market for another job after demitting office.¹²⁷ If, however, the information is released prior to hiring, and if the shareholders decide that the demands are excessive, it has the effect of signaling to shareholders of other companies, where the person is a candidate for a similar position, that she is not a good type, and will negatively impact the candidate's marketability. Thus, a law requiring disclosure of proposed pay prior to CEO hiring can influence the internalization of a norm against excessive pay, but at significant cost. In the case of directors, the signaling function is served both before, and after the compensation package has been approved because directors frequently have an interest in being reelected and appointed to other boards. Directors will be influenced to monitor and constrain pay more effectively because they want to show shareholders that they can effectively manage their assets, and that they are attractive candidates for appointment to other boards.

Professor Cooter's work provides another interesting element that ties in with the internal aspects of normative behavior- the nature of individuals to engage in Pareto self-improvements.¹²⁸ The state can facilitate Pareto self-improvements through legal instruments.¹²⁹ For example, when the state passes a law banning smoking in public places, many citizens internalize the norm against smoking in public places as a Pareto self-improvement.¹³⁰ Several others may obey the law for instrumental reasons.¹³¹ When these two factors operate together, a new behavior can result.¹³² In Cooter's scheme, internalization can be leveraged by the law to change preferences by aligning the law with morality, relying upon the innate respect for the law

¹²⁵ See Cooter, *supra* note 90, at 587.

¹²⁶ *Id.*

¹²⁷ Lynn Stout makes a similar point: "external incentives, alone, can only influence the behavior of the rationally selfish actor when two criteria are met. First, her behavior must be observable to others. Second, some one (or something) must be both willing and able to reward her good behavior and to punish her bad behavior – and to reward or punish sufficiently." Lynn Stout, *Other-Regarding Preferences and Social Norms* 20 (Geo. U. Law Cen., Bus., Econ., and Reg. Policy and Pub. Law and Legal Theory, Working Paper No. 265902, 2001), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=265902.

¹²⁸ Cooter, *supra* note 25, at 586.

¹²⁹ *Id.*

¹³⁰ See *id.* at 592 & 594.

¹³¹ *Id.* at 594.

¹³² *Id.*

as an instrument, and by relying on self-motivated improvements to stimulate good acts.¹³³

This concept of Pareto self-improvement might hold saliency for the CEO compensation problem. The condemnation of excessive compensation invokes one of the oldest moral offenses – greed – making it possible for norms entrepreneurs to create conditions that facilitate Pareto self-improvements in corporate CEOs and directors. It is rather optimistic to suppose that the average CEO will be stopped by moral objections to greed, but directors, who have less to gain from greed in economic terms, will engage in a process of Pareto self-improvement to better correlate compensation with performance.

The self-improvement aspect is crucial because, in the absence of internalization of the norm, no amount of legislative or regulatory activity can bring about true social transformation. It might succeed in making directors and CEOs more careful, and is more likely to result in the invention of new techniques that conceal the true size of compensation packages.¹³⁴ Internalization diverts their energies away from such strategies and can create a norm correlating pay with performance. There is some evidence that this is not happening in sufficient measure and that the relevant actors are still expending energies in socially unproductive ways to conceal information so as to stymie the deployment of social sanctions.¹³⁵

4. *The Importance of Networks*

Social norms theories emphasize the role of networks, making them particularly amenable to application in the CEO pay debate. McAdams's esteem-based model is heavily dependent on group or network membership – the underlying idea is that we value what other people think about us, and constrain our unfettered autonomy by belonging to groups.¹³⁶ If membership is so valuable, the argument is that people will go a long way to preserve it, and expulsion from the group serves as a powerful sanction.¹³⁷ This is confirmed by several studies.¹³⁸ Group membership puts a lid on members' proclivities to gain advantages by short-term competitive behavior – based on the idea that these short-term benefits are smaller than

¹³³ *Id.* at 596.

¹³⁴ Phred Dvorak, (New Math) x (SEC Rules) + Proxy=Confusion, Wall Street Journal, March 21, 2008; Page A1, http://online.wsj.com/article/SB120604424097452677.html?mod=todays_us_page_one (writing that following the new SEC compensation disclosure rules, Applied Materials' "compensation section contains 16,245 words -- twice the length of the U.S. Constitution and its 27 Amendments -- along with 10 formulas, 10 tables and 155 percent signs.")

¹³⁵ The SEC's review of the compensation disclosure in 350 companies following the issuance of its disclosure rules stated: "[w]e often found it difficult to understand how companies used these performance targets or considered qualitative individual performance to set compensation policies and make compensation decisions." Staff Observations in the Review of Executive Compensation Disclosure, available at <http://www.sec.gov/divisions/corpfin/guidance/excecompdisclosure.htm>.

¹³⁶ McAdams, *supra* note 255, at 355-57.

¹³⁷ *Id.* at 366-72.

¹³⁸ Bernstein, *supra* note 2929, at 138-39.

those provided by membership in the group.¹³⁹

McAdams premises his esteem thesis on the idea that humans are social animals, and that acceptance by others is inherently important.¹⁴⁰ It does not matter that other rewards flow from acceptance.¹⁴¹ If acceptance is its own reward, then people will behave in ways aimed at attaining acceptance, even in the absence of other rewards, and the presence of other costs.¹⁴² Purely self-interested behavior will be constrained to the extent that it invites disapprobation, or fails to win approbation.

Group or club membership also has other significant purposes; for example to signal type to onlookers. Membership in the Sierra Club signals environmental friendliness, whereas belonging to the National Rifle Association, signals conservative credentials. Thus, membership itself is a source of information about type.¹⁴³ In many instances, the cost of membership is low relative to the benefits of signaling and individuals join purely to send the signal despite disagreeing with the ideology of the group.¹⁴⁴ Some scholars give the example of voting as being of trivial benefit in terms of costs and benefits (on the idea that each individual vote may be worth little), but is engaged in because of the message it conveys to society that the voter is a responsible member.¹⁴⁵

Studies have shown that groups establish norms even in incipient or protean conditions, and that these norms seem to persist even when the group is absent.¹⁴⁶ This has significant ramifications for corporate law because shareholders of a company are not a constant group, and are organized around a loose set of common values. If weak groups can generate norms, so can shareholders of a company. Further, the entire shareholding public constitutes an even looser grouping in broader society. This shareholding group can also generate a norm against excessive CEO pay. A more relevant group is comprised of directors. Board membership is valuable, and shareholder-friendly norms can be generated by this group purely for self-interested reasons. Violators can be punished by exclusion. This group has strong incentives for self-policing because of the desire to stave off negative attention from competing groups (like shareholder activists) because of the risk of tougher regulation resulting from such attention.

¹³⁹ *Id.* at 138-43.

¹⁴⁰ McAdams, *supra* note 255, at 355-57. The core assumption of esteem theory is that people have a preference for something that other people can give or withhold at zero cost: esteem. *Id.* at 365. The assumption serves to avoid the collective action problem of norm enforcement. *Id.* Because esteem is costless it is not subject to a free rider problem. *Id.* at 364. Although the preference for esteem is assumed to be slight, McAdams shows that it can explain even very costly norm-guided behavior.

¹⁴¹ *See id.* at 355.

¹⁴² *See id.* A similar idea is contained in the peer-pressure based model of Kandel and Lazear. *See generally* Eugene Kandel & Edward P. Lazear, *Peer Pressure and Partnerships*, 100 J. POL. ECON. 801 (1992).

¹⁴³ POSNER, *supra* note 62, at.

¹⁴⁴ *Id.* at ____.

¹⁴⁵ This is doubtful given the low voting turnout from the more affluent sections of society in several countries.

¹⁴⁶ *See, e.g.,* Jeffrey J. Rachlinski, *The Limits of Social Norms*, 74 CHI.-KENT L. REV. 1537, 1548 (2000) (explaining the results of Sheriff's experiments).

Is group size relevant to the operation of norms? McAdams asserts that “[o]n average, the smaller the group, the more intensely esteem is valued.”¹⁴⁷ This would pose problems in the CEO pay context because of the size of the investing public being large. Closer examination reveals that McAdams may have it backwards. The smaller the group, the more important and unsubstitutable each individual becomes for cooperative interactions. Therefore, regardless of esteem, group members have little choice but to engage in cooperative relationships with each other. For example, a small village with just two carpenters has little choice but to engage in relationships with them although both have reputations for being tardy and delivering poor-quality work. Analogous situations are commonplace in real life. In fact, if esteem is valued at all, it is in larger groupings where cooperative relationships involve meaningful choice predicated on accessible information. Rather than group size, the value of esteem is predicated on the internalization of some kind of other-regarding norm.

McAdams might be mistaken when he writes that “[b]y definition, members of an individual’s group have more information about the individual than do strangers, and thus the esteem of group members tends to matter a great deal more.”¹⁴⁸ When people have a great deal of information about the individual, the more likely effect is indifference to esteem. This might explain the differences in the kinds of interactions in marital and familial relationships depending on how much time has elapsed in the relationship. In the early stages of a marriage, it is frequently the case that each spouse cares strongly about esteem from the other spouse and their families. The longer the marriage lasts, the less concern there is for such esteem, explaining perhaps partly, the currency of mother-in-law jokes in popular culture. It is only when people know very little about others that there is a quest for esteem, if at all. The key to esteem appears to be the importance that the individual confers to the esteem-giver. If the esteem-giver’s opinion is not valued, regardless of the size of the group, esteem will not matter as a constraint on behavior.¹⁴⁹

Notwithstanding the difficulties identified by this analysis of the process of norm creation and enforcement, there are useful lessons for the CEO compensation problem. The shareholder wealth maximization norm is commonly accepted in corporate law.¹⁵⁰ It is indeed the basis for

¹⁴⁷ McAdams, *supra* note 255, at 389.

¹⁴⁸ *Id.* at 390.

¹⁴⁹ McAdams seems to recognize this point when he writes that “other things equal, the more an individual esteems another, the more she values the opinion the other holds of her.” *Id.* He does not do it full justice.

¹⁵⁰ See, for example, *Dodge v. Ford Motor Co.* 204 Mich. 459, 170 N.W. 668, 684 (1919) (“A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end.”); *Granada Investments, Inc. v. DWG Corp.*, 823 F.Supp. 448, 459 (1993): “As corporations developed and grew, a central principle of corporate law emerged: the sole duty of a corporation’s officers is to maximize shareholder wealth. ... the principle that a corporate officer’s overriding duty is to maximize shareholder wealth remains intact. ... Today, this appears to be the dominating goal of corporations in a free market society.” (internal citations omitted); For academic support, see, Mark Roe, *The Shareholder Wealth Maximization Norm And Industrial Organization*, 149 U. Pa. L. Rev. 2063, 2065 (2001) (“Shareholder wealth maximization is usually accepted as the appropriate goal in American business circles.”); Stephen Bainbridge, *In Defense of the Shareholder*

our whole system of director liability.¹⁵¹ Moreover, the corporate director universe is extremely interdependent. Commercial and social linkages are so strong that no director can be oblivious to the negative fallouts from violating the norm. These fallouts can, inter alia, take the form of lost business opportunities, withdrawal of job offers, the flight of capital, the collapse of the company's stock, the derision of peers, removal from other boards, and expulsion from social clubs and professional organizations.

The esteem model has traction in the CEO compensation area because director candidates are substitutable, and given the size of the group, selection is predicated on reputation. The efficacy of the model is dependent on the identity of esteem-givers. If CEOs derive esteem from other CEOs, expressions of disesteem by shareholders and other actors will not be a constraint. It is only if shareholders are the relevant esteem-givers in the eyes of the CEO that disesteem works as a constraint. If shareholders have the ability to convey disesteem in a manner that carries teeth, through secondary sanctions on directors, or directly through voting, then CEOs have no choice but to value their esteem. Unlike CEOs, directors do not have the luxury of looking solely at other directors as esteem-givers, and need esteem from shareholders to maintain their positions of the board. This makes them ripe targets for shareholders. Norms entrepreneurs and legislators ought to direct their energies at ensuring disesteem from the relevant esteem-givers if sanctions have to be effective.

5. *Norm v. Law*

Norms are not born of formal processes of promulgation, which can be both an advantage and a disadvantage. It can often be the latter because of the absence of the pathways that conventional legislation offers for improvement and amendment.¹⁵² Amendment is frequently dependent on the agendas of norms entrepreneurs and their ability to leverage the support of the state.¹⁵³ The absence of formal processual checks can also allow the amendment process to be hijacked by lobbies and there is an element of democratic deficit that can be troubling.¹⁵⁴ It is small consolation that the formal legal process is beset by the same interest group pressures.

There, however, is a marked advantage enjoyed by norms in terms of their malleability. Legislation runs the risk of fossilization because of the relative difficulty of achieving the processual support for effecting amendments. The status quo can also be in a state of petrification due to constraints on legislative time and political costs associated with enacting new legislation. Norm creation can often be easier to achieve, primarily because of the absence of processual constraints.

Wealth Maximization Norm: A Reply to Professor Green, 50 Wash. & Lee L. Rev. 1423 (1993) (“Shareholder wealth maximization long has been the fundamental norm which guides U.S. corporate decisionmakers.”)

¹⁵¹ *Revlon, Inv. v. MacAndrews & Forbes Holdings, Inc.* 506 A.2d 173, 184 (1985).

¹⁵² See Cooter, *supra* note 115, at 1655 (discussing H.L.A. HART, *THE CONCEPT OF LAW* (1961)).

¹⁵³ See Curtis J. Milhaupt, *Creative Norm Destruction: The Evolution of Nonlegal Rules in Japanese Corporate Governance*, 149 U. PA. L. REV. 2083, 2126 (2001).

¹⁵⁴ See *id.*

PART III: THE ROLE OF NORMS ENTREPRENEURS

1. Norms Entrepreneurs Defined

The literature on social norms has introduced the concept of “norm entrepreneur,” a term popularized by Cass Sunstein.¹⁵⁵ While the term is not free from objections, in the interest of harmony within the social norms scholarship, this Article will continue with its use. A norm entrepreneur is an agent responsible for the invention or evolution of new social norms.¹⁵⁶ Ellickson defines “norm entrepreneurs” as people who “possess a relatively high level of technical knowledge relevant to the norms within [their] specialty. . . . [and are] likely to be cognizant that there are appreciative experts . . . who are likely immediately to esteem the norm entrepreneur for trying to change the social practice at issue.”¹⁵⁷ “Change agents” are also suppliers of new norms.¹⁵⁸ Technical knowledge and leadership skills allow them to bear the opportunity costs of norm reform. Norm entrepreneurs are likely to be more successful at creating norms than the state because of their embeddedness in the community.¹⁵⁹ Norm entrepreneurs create new norms by blatantly acting in a way that defies or transcends existing social norms, signaling to observers that they, in turn, should copy the new behavior.¹⁶⁰ If this is taken up by the observers, a new norm can result.¹⁶¹ Elected representatives,¹⁶² high-profile CEOs and corporate leaders,¹⁶³ institutional shareholders, blue ribbon panels, proxy firms, and the media can work as norm entrepreneurs in the corporate law area.¹⁶⁴

Norm entrepreneurs do not create new norms for altruistic reasons; acting as a norm entrepreneur can result in economic benefits.¹⁶⁵ Commercial entities might act as norms

¹⁵⁵ See Sunstein, *supra* note 32, at 909.

¹⁵⁶ *Id.*

¹⁵⁷ Ellickson, *supra* note 120, at 19.

¹⁵⁸ Milhaupt, *supra* note 153, at 2112 (giving the example of Murakami in Japanese corporate law).

¹⁵⁹ Posner and Rasmusen make a similar point, arguing that “[n]ongovernmental organizations may be more effective than either individuals or governments in this regard, but it is not clear whether a society that gives ample scope to norm changing organizations will have more or less norm creation and stability.” Posner & Rasmusen, *supra* note 107, at 379.

¹⁶⁰ See generally Sunstein, *supra* note 322.

¹⁶¹ See *id.* at 929-30.

¹⁶² Paul M. Schwartz & Edward J. Janger, *Notification of Data Security Breaches*, 105 MICH. L. REV. 913, 956 (2007).

¹⁶³ See Jayne W. Barnard, *Corporate Boards and the New Environmentalism*, 31 WM. & MARY ENVTL. L. & POL’Y REV. 291, 301 (2007).

¹⁶⁴ See Troy Paredes, *The Importance of Corporate Law: Some Thoughts on Developing Equity Markets in Developing Economies*, 19 PAC. MCGEORGE GLOBAL BUS. & DEV. L.J. 401, 405 (2007) (recognizing the media as a norm entrepreneur as well: “In addition, one cannot overlook the influence of the financial and business media. Critical coverage on CNBC or in the *Wall Street Journal* can affect a company, in part by shaming management and the board to shape up and reconsider its business plan and governance structure.”).

¹⁶⁵ Many other scholars seem to imply that norm entrepreneurs act without regard to reward. See, e.g., Martha Finnemore & Kathryn Sikkink, *International Norm Dynamics and Political Change*, 52 INT’L ORG. 887, 898 (1998) (asserting that norm entrepreneurs in the political arena tend to be motivated by “empathy, altruism, and ideational commitment”); Sunstein, *supra* note 32, at 929-30 (asserting that norm entrepreneurs in the political sphere serve to

entrepreneurs when they “use advertisements to promote a style of life that requires the purchase of their goods.”¹⁶⁶ In Posner’s signaling model, senders of signals rely on “the suggestions of authoritative norm entrepreneurs . . . [a]s long as enough senders follow the suggestion of a person, he will become an authentic norm entrepreneur.”¹⁶⁷ Norms entrepreneurs announce certain behaviors as signals in order to ensure that people are able to distinguish signals from non-signals. Their payoffs are dependent on the number of people who imitate the issued signal.¹⁶⁸ Posner’s norm entrepreneurs include “[a]rbiters of taste,” “sellers of consumer goods,” consultants, “protocol experts,” academics, journalists, politicians, and political activists.¹⁶⁹

If, as Posner claims, norm entrepreneurs get higher rewards depending on how many people follow their signals, it should then be in their interest to cater to the lowest common denominator. This undercuts his basic thesis: no useful purpose is served in terms of facilitating the choice of partners for cooperative interactions if all of the people or, an overwhelming majority is part of the group following the signal. If the model has to work, it is not the number of people following the lead of the norm entrepreneur that is the determining factor, but the type of people that do. Thus, even a small number of the right type ought to suffice – a point that Posner does not address.

Norms entrepreneurs play a role in the Posnerian scheme in enforcement at the secondary level (by social sanctions like shaming, shunning, etc.) by conveying the message that such enforcement is a signal. Norm entrepreneurs canvass the punishment of people who deviate, helping those who want to signal a low discount rate to engage in this costly signaling behavior.¹⁷⁰ They also work to clarify signals in order to clear up ambiguities that arise.¹⁷¹ Many of the people that Posner regards as norms entrepreneurs cannot be so called at all: celebrities, fashion gurus, etc., are not advocating the creation of any norm, most of the time. Their actions in terms of purported norm creation may be entirely inadvertent and accidental. Even when people follow their lead, they do so not out of any sense of obligation, but out of taste. This explains why fads and fashions pass so quickly. There is no element of internalization; all that is transpiring in these circumstances is that people are imitating celebrities and their ilk. Mere imitation does not create a norm; the conduct must arise out of a sense of obligation. The incredibly large number of “celebrities” has contributed to so much dissonance about any given fad that there is no meaningful signaling function that can be served by mere imitation for short periods of time. Frequently, fads disappear even before their existence is properly acknowledged, proving that this type of behavior is not normative.

overcome the “free rider problem” inherent in replacing an old norm with a new norm).

¹⁶⁶ Valerie Jaffee, Note, *Private Law or Social Norms? The Use of Restrictive Covenants in Beaver Hills*, 116 YALE L.J. 1302, 1329 (2007); Richard H. McAdams, *Signaling Discount Rates: Law, Norms, and Economic Methodology*, 110 YALE L.J. 625, 626 nn.6-11, 627 n.12 (2001) (reviewing POSNER, *supra* note 62).

¹⁶⁷ Posner, *supra* note 59, at 774.

¹⁶⁸ POSNER, *supra* note 62, at 30.

¹⁶⁹ *Id.* at 31-32.

¹⁷⁰ *Id.* at 90.

¹⁷¹ *Id.* at 139 (arguing that the ambiguity of signals creates incentives to create new signals).

In the McAdams model, when a particular behavior is sought to be entrenched as a norm, “[t]he first few members to bear the cost of the idealized behavior X may capture the status of ‘hero.’”¹⁷² Esteem attaches to the early followers of these “heroes.” McAdams recognizes that the early movers have to bear the risk of isolation if there are no followers.¹⁷³ However, he notes that the risky gamble is the reason for them to be held in high esteem if they succeed.¹⁷⁴ One might, in this context, imagine the plight of those who volunteer to perform on television shows or sporting contests, risking ridicule, as being similar to these heroes. McAdams’s error is that he does not distinguish between ordinary early movers and valuable early movers. This element is vital in predicting successful reception of the asserted norm. If the early mover has low value to the target – for example, a distant relative in the family context – there is little or no chance that his action will be followed. In contrast, if it is a parent, adoption of the norm is likely.

Despite this, McAdams contends that the very fact that the “hero” decided to engage in a particular conduct has the effect of “raising the price others must now pay for refusing to engage in that behavior. . . . [W]hen everyone refused to undertake X, the esteem loss from that decision was zero. But where some engage in the idealized activity, those who do not are negatively distinguished and now bear some loss of esteem.”¹⁷⁵ This does not seem to accord with his view that the norm entrepreneur bears a risk that no one will follow his lead. If no one follows, or if only a few follow, it is unlikely that there is any loss of esteem experienced by those that do not. Thus, the mere fact that a norm entrepreneur engaged in a particular conduct does not raise the price of nonconformity; it is only when there has been a critical mass of valuable acceptances that such a price gets imposed on those who do not follow.

This concept is captured by Andreas Engert, who identifies “network effects as being a key determinant in norm creation.”¹⁷⁶ Network effects might help to explain the mixed success of attempts at changing social norms in the CEO pay area. The bandwagon effect created by pension funds and labor unions, allied with the various attempts at regulatory and legislative intervention shows that a norm against CEO greed is a serious candidate for successful reception and

¹⁷² McAdams, *supra* note 255, at 369-70.

¹⁷³ *Id.* at 370 (“If very few individuals contribute labor to patrol the neighborhood or to recycle, the joint return may be negligible, and the sacrifice by these individuals may seem senseless and naive. Foolish idealism is often not esteemed.”).

¹⁷⁴ *Id.*

¹⁷⁵ *Id.*

¹⁷⁶ Andreas Engert, *Norms, Rationality, and Communication: A Reputation Theory of Social Norms* 30-31 (Ludwig Maximilians Univ. of Munich, Inst. of Int’l L. – Comp. L., Working Paper No. Z13, 2002), available at <http://ssrn.com/abstract=323020>.

“Heroes” may trigger the emergence of a new norm by incurring sacrifices. So long as their endeavor is that of a few dispersed individuals their attempt remains futile. If they fail they are ridiculed. However, if they succeed they trigger a competition for compliance up to the point where the proposal has become the new standard. One crucial condition of success for a hero is to be a “norm entrepreneur” at the same time, that is, to convey to their audience why the new behavior is useful and thus deserves esteem (or reputation). Hence the mixture of eloquence and resoluteness that accounts for charismatic leadership.

Id.

entrenchment.¹⁷⁷ This might explain the enormous interest in news coverage of CEO compensation issues. It is also evidenced by the decision of companies like Aflac to grant shareholders a say on pay even without the passage of a resolution at the annual general meeting.¹⁷⁸

2. Norms Entrepreneurs in the CEO Compensation Arena

The principal norms entrepreneurs in the CEO compensation arena have been institutional shareholders, proxy advisory firms, labor unions, and the media. They have engaged in campaigns to pass say on pay resolutions at companies perceived to have compensation agreements inadequately correlated to performance. The work of these entrepreneurs has created a political climate conducive to legislative action by politicians for instrumental reasons. Exemplifying a rare phenomenon, Professor Lucian Bebchuk has emerged as a major norm entrepreneur in the CEO compensation area, primarily by dint of his scholarship. His campaign to increase shareholder power is primarily by writing and speaking prolifically on the topic.¹⁷⁹ Bebchuk has recently taken a more activist role as a norms entrepreneur by submitting proposals at annual meetings at several companies.¹⁸⁰ Other norms entrepreneurs have to rely mainly on this tactic, as evidenced by the 2006 proxy season witnessing 23.9% of shareholder proposals on executive compensation.¹⁸¹ A major example of the proxy route being effectively deployed is the work of the American Federation of State, County, and Municipal Employees (AFSCME) pension plan, which sponsored proposals at several corporations aimed at giving shareholders an advisory vote on executive compensation, securing 37% and 47% favorable votes at Morgan

¹⁷⁷ As Engert notes, “If a proposed norm would have strong network effects, players are sensitive to whether or not it will become effective. Accordingly, players tend to provide incentives for others to inform them, i.e.[,] to speak out about their own opinion as well as the opinion distribution over the population. However, this interest only exists if the proposal is a serious candidate for becoming the norm. If it is not, players are especially uninterested even if, in substance, they would strongly prefer the norm to be introduced.” Id.

¹⁷⁸ <http://www.aflac.com/us/en/aboutaflac/PressReleaseStory.aspx?rid=962932>; Allan Sloan, *Aflac Looks Smart on Pay*, WASH. POST, May 29, 2007, at D1, available at <http://www.washingtonpost.com/wp-dyn/content/article/2007/05/28/AR2007052801055.html>.

¹⁷⁹ See generally Lucian A. Bebchuk & Robert Jackson, Jr., *Executive Pensions*, 30 J. CORP. L. 223 (2005); Lucian A. Bebchuk & Jesse M. Fried, *Executive Compensation at Fannie Mae: A Case Study of Perverse Incentives, Nonperformance Pay, and Camouflage*, 30 J. CORP. L. 807 (2005); Lucian Arye Bebchuk & Jesse M. Fried, *Stealth Compensation via Retirement Benefits*, 1 BERKELEY BUS. L.J. 291 (2004); Lucian Arye Bebchuk & Jesse M. Fried, *Executive Compensation as an Agency Problem*, 17 J. ECON. PERSP. 71 (2003); Lucian Arye Bebchuk, Jesse M. Fried & David I. Walker, *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751 (2002); Lucian Bebchuk & Yaniv Grinstein, *The Growth of Executive Pay*, 21 OXFORD REV. OF ECON. POL’Y 283 (2005); Lucian Bebchuk & Yaniv Grinstein, *Firm Expansion and CEO Pay* (Nat’l Bureau of Econ. Res., Working Paper No. 11886, 2005), available at <http://ssrn.com/abstract=875737>.

¹⁸⁰ See Lucian Arye Bebchuk’s Policy & Advocacy, <http://www.law.harvard.edu/faculty/bebchuk/policy.shtml> (last visited February 18, 2008).

¹⁸¹ *Empowering Shareholders on Executive Compensation: Hearing before the H. Comm. on Finan. Servs.*, 110th Cong. 2 (2007) (statement of Lucian A. Bebchuk, Professor, Harv. L. Sch.).

Stanley and Bank of New York, respectively.¹⁸² Some examples of norms entrepreneurs' work will be considered in the following paragraphs.

A. Home Depot

The company's weak stock performance seems to have made it a ripe target for the work of norms entrepreneurs. In 2005, shareholders approved a non-binding proposal asking the company to seek their permission prior to issuing golden parachutes to senior executives.¹⁸³ The proposal required approval of golden parachutes that exceed 2.99 times basic pay and bonus.¹⁸⁴ The main ground for attack was the anger generated by high levels of compensation for CEO Nardelli as Home Depot's stock continued to languish in comparison with its competitor Lowe's.¹⁸⁵ Nardelli allegedly made about \$245 million during five years when the stock declined by 12 percent in contrast to a growth of 140% for Lowe's.¹⁸⁶ Nardelli's high compensation also drew attention because of the possible conflicts of interest created by board members' close ties to him.¹⁸⁷ CalPERS, the nation's largest pension fund, and a major norms entrepreneur, urged shareholders to support a proxy proposal giving an advisory vote on pay for the top five executives.¹⁸⁸ Several norms entrepreneurs, including AFSCME, the Connecticut pension fund, CalPERS, and ISS acted in concert to withhold votes from board members.¹⁸⁹ The board's lax

¹⁸² Joseph A. Giannone, *Shareholders Reject "Say on Pay"*, REUTERS, Apr. 10, 2007, available at <http://www.reuters.com/article/businessNews/idUSN1040609620070410?feedType=RSS>. Institutional Shareholder Services reports that over sixty proposals of a similar nature have been filed by pension funds and activists this year. See 2006 Postseason Report: Spotlight on Executive Pay and Board Accountability, available at http://blog.riskmetrics.com/2007/07/preliminary_postseason_reports.html.

¹⁸³ Renee Degross, *Stockholders flex their muscles*, 5/27/05 Atlanta J. & Constitution, F1, 2005 WLNR 8402914. The proposal was moved by Trowel Trades, a union investment arm, which called it a "basic fundamental shareholder power."

¹⁸⁴ Home Depot's board objected to this claiming that it would "choke[its] ability to . . . attract, motivate and retain senior leadership." Id.

¹⁸⁵ Renee Degross, *Home Depot Stock a bit of a Wallflower*, Atlanta J. & Constitution, F1, 6/17/05, 2005 WLNR 9596505; Renee Degross, *CEO beats peers in pay*, 4/15/06 Atlanta J. - Const. B1 2006 WLNR 6336646 ("The pay for Lowe's former chairman is a quarter of Nardelli's annual pay, and Lowe's has outperformed Home Depot in the last six years.")

¹⁸⁶ California Public Employees Retirement System Calls on Home Depot Shareowners to Support Advisory Executive Compensation Proposal, US State News, 5/15/06, 2006 WLNR 8384920.

¹⁸⁷ Julie Creswell, *Gilded Paychecks: Ties That Bind*, 5/24/06 N.Y. Times A1 2006 WLNR 8880885 ("two board members have ties to Nardelli's former employer General Electric, one used Nardelli's lawyer to negotiate his own salary and three either sat on other boards with Home Depot's influential lead director Kenneth G Langone or have ties to companies doing business with Langone; five of six members of compensation committee are active or former chief executives likely influenced by their own high pay.")

¹⁸⁸ Id. The chair of CalPERS' investment committee was quoted as saying "we have lost money on the inability of the company to align its interests with shareowners which . . . is egregious compensation for poor performance."

¹⁸⁹ Id. (quoting ISS as saying "poor compensation design, a lucrative employment agreement, and arguably egregious compensation practices call into question the fitness of the company's Compensation Committee members to serve as directors").

enforcement of the shareholder wealth maximization norm was pointed out by the Corporate Library, a norms entrepreneur, which included Home Depot in its list of 11 “Pay for Failure Companies.”¹⁹⁰ Things came to a head when Home Depot ignored the ferment and conducted a farcical annual meeting in 2006 with the board choosing not to attend, despite which all members were reelected.¹⁹¹ However, ten out of eleven directors at Home Depot received 30 - 36% withhold votes,¹⁹² with Mr. Nardelli receiving 32 % withhold votes.¹⁹³ A resolution requiring majority voting for director election was passed.¹⁹⁴ Richard Ferlauto, a union activist, even adopted maverick tactics to promote the say on pay resolution by attending the Home Depot meeting wearing a chicken suit.¹⁹⁵ There were angry responses from shareholders following this meeting and Home Depot was forced to apologize. A few months after the farce, an investor threatened a proxy fight.¹⁹⁶ The series of events culminated with the resignation of Mr. Nardelli in January 2007, much to the satisfaction of his critics.¹⁹⁷ The company’s 2007 annual meeting was a markedly different affair with shareholder activists being treated with more respect than in years past.¹⁹⁸ Norms entrepreneurs like Professor Bebchuk enjoyed unprecedented success despite owning only ninety shares – his proposal to require two-thirds board approval for executive compensation was approved.¹⁹⁹ Home Depot exemplified a general willingness to

¹⁹⁰ Id. (“The [performance] target for Mr. Nardelli had been total shareholder return -- share price increases plus reinvested dividends -- compared with a peer group, and the company was performing poorly by that measure in 2003.... But that year, the board changed the target to one of growth in average diluted earnings per share, which takes into account the per share earnings decrease that occurs when stock options are awarded.”)

¹⁹¹ Joe Nocera, The Board Wore Chicken Suits, 5/27/06 N.Y. Times C1 2006 WLNR 9112614

¹⁹² Id. In a reference to the absence of the directors from the meeting, Gerald W. McEntee, chairman of the AFSCME Pension Plan said: “The board of directors at Home Depot abdicated their responsibility and in doing so, they ducked a basic accountability obligation to company shareholders. The real question is what are they trying to hide?” Id. at 21.

¹⁹³ Gretchen Morgenson, A Warning Shot by Investors to Boards and Chiefs, 1/4/07 N.Y. Times C1 2007 WLNR 134864; Chad Terhune & Joann Lublin, At Home Depot, CEO Pay Rage Boils Over in Vote, Wall Street Journal, 6/2/2006, A2, quoting ISS’s exec. VP as saying: “[p]ay rage drove the significant withhold vote at Home Depot,” and Richard Ferlauto of AFCME as saying “This was a very strong rebuke of the Home Depot directors across the board.”

¹⁹⁴ Home Depot Approves Majority Voting, 8/30/06 CFO Mag. for Senior Fin. Executives 2 2006 WLNR 15549876.

¹⁹⁵ Id. (reporting that protesters were chanting, "Hey Bob, why are you chicken/while the stock price takes a lickin'!")

¹⁹⁶ Suzanne Kapner, Home Wrecker; Shareholder Battles to Change Management, 12/19/06 N.Y. Post 45, 2006 WLNR 22125013. Surprisingly, Home Depot said that it planned to meet with the investor to address their concerns; The proxy fight did not materialize after the parties reached agreement to give Relational a seat on the board and for four directors who hired Nardelli to demit their seats in 2008. Home Depot Proxy Fight Is Settled, 2/6/07 N.Y. Times C1, 2007 WLNR 2244223.

¹⁹⁷ Id.

¹⁹⁸ Joe Nocera, Speaking Up In Fresh Air At Home Depot, 5/26/07 N.Y. Times C1 2007 WLNR 9883357. (“Richard Ferlauto, the director of pension investment policy at the American Federation of State, County and Municipal Employees pension fund, led a delegation of shareholder activists that met privately with the board’s nominating committee.”)

¹⁹⁹ Jena McGregor, Activist Investors Get More Respect, 6/11/07 Bus. Wk. 34

negotiate with activists to arrive at settlements prior to the meeting.²⁰⁰ For a company that had been hostile to shareholder concerns, this was a remarkable turnaround. It is unlikely that behavior modification was the result of internalization for all board members, but at least the new CEO seems to have internalized relevant norms.²⁰¹ This is unlikely to have been possible without the work of norms entrepreneurs.

B. Blockbuster

Blockbuster saw significant activity due to high compensation for its CEO John Antioco despite declining business. One of the most significant attacks came from Carl Icahn, its largest shareholder, who criticized Antioco's \$51 million pay package as excessive.²⁰² He launched a proxy fight and put himself forward for election to the board along with two nominees. Other norms entrepreneurs like ISS stepped into this proxy battle and advised shareholders to vote for the two nominees but not for Mr. Icahn.²⁰³ Curiously, Mr. Antioco welcomed ISS's support despite it having opposed his candidates!²⁰⁴ Icahn's slate handed Mr. Antioco an embarrassing defeat at the election.²⁰⁵ Mr. Antioco was reappointed to the board despite previously stating that he would resign if defeated, but harsh consequences were impending. In 2007, he was in a dispute with the board over bonus payments – the board sought to pay him a 2.28 million bonus when Mr. Antioco claimed that he was entitled to \$7.65 million.²⁰⁶ The board threatened to pay him no bonus if he challenged their decision.²⁰⁷ This unseemly mess culminated in his agreeing to leave the position with a bonus of \$3.1 million and a severance payment of just \$5 million

2007 WLNR 10599687 (quoting Bebchuk saying "I did not expect [they] would be willing to make changes in the bylaws in response to a proposal by someone who really is an individual shareholder." McGregor writes that "[a]fter a couple of conversations and e-mails with Bebchuk and a discussion with outside counsel, the home-improvement retailer adopted the proposal outright. In exchange, Bebchuk agreed to withdraw the resolution.")

²⁰⁰ Id. ("shareholders and boards are negotiating away a near-record number of proposals ahead of meetings. So far this year 22% of all proposals have been withdrawn by investors, up from 15% at this point last year.")

²⁰¹ Joe Nocera, Speaking up in Fresh Air at Home Depot, 5/26/07 N.Y. Times C1 2007 WLNR 9883357, quoting board member Kenneth Langone.

²⁰² Icahn Warns Blockbuster to curb spending, 4/8/05 NY Times C3, 2005 WLNR 5492572; Icahn to Nominate Three Directors at Blockbuster, Wall Street Journal, 4/8/05, B6 ("Mr. Icahn said Mr. Antioco's pay packages are "unconscionable"); Blockbuster-Icahn Dispute Intensifies

Ceo Says Remarks About Spending Are 'Misleading', 4/19/05 South Florida Sun-Sentinel 3D

2005 WLNR 23659508 ("Antioco said his pay package, including \$2.05 million in salary, a bonus of \$5 million, restricted stock worth \$26.8 million, options on 5 million shares and other compensation of \$153,500, was designed by independent directors to "align my interests with the interests of Blockbuster's shareholders."")

²⁰³ Firm supporting two of Icahn's allies, 5/4/05 Ft. Worth Star-Telegram C1 2005 WLNR 6966250.

²⁰⁴ Id. (quoting him: "'I'm pleased ISS has recommended that shareholders withhold their vote from Mr. Icahn and believes that my removal from the board is not warranted...")

²⁰⁵ Dissident Icahn Wins Board Seat at Blockbuster, Wall Street Journal 5/12/05, A1.

²⁰⁶ Icahn Seeks to Pare Bonus of Blockbuster Chief, Wall Street Journal 2/28/2007 B11; CEO is seeking bigger bonus, 2/28/07 Ft. Worth Star-Telegram, 2007 WLNR 3839940.

²⁰⁷ Id.

with two years left on his contract.²⁰⁸ Mr. Icahn's influence was evident in the hard negotiations that reduced the severance payment from \$13.5 million under Antioco's contract to the eventual \$5 million, bringing to sharp relief the poor work of Disney's board in paying staggering severance amounts to its CEO, Michael Ovitz.²⁰⁹ The success of such an aggressive strategy ought to inspire other boards to negotiate with CEOs on their way out.²¹⁰ In a further victory for shareholder activists, Mr. Antioco's replacement was offered significantly less salary and bonus in addition to being required to buy \$3 million worth of stock in the company.²¹¹

Mr. Icahn was not the only norms entrepreneur at work at Blockbuster - the New York City Employees' Retirement System ("NYCERS") championed a say on pay resolution in 2007 and obtained 57% support.²¹² The proposal had been vehemently opposed by the board in language very similar to that used at several other companies.²¹³ Following its defeat, the company tersely

²⁰⁸ Blockbuster Chief Agrees To Exit Deal, 3/21/07 N.Y. Times C1 2007 WLNR 5326101.

²⁰⁹ Id. quoting Mr. Icahn: "I really believe contracts like this are one of the things wrong with corporate America. When you have these huge severance packages, it so obviously undermines any type of accountability." Further, "I feel the contract has been sort of an albatross around the company's neck... You should reward people if the stock goes up. You shouldn't have contracts like this."

²¹⁰ Video giant slashes exit pay, Blockbuster's CEO agrees to a deal to leave by year-end for 62% less than he had expected, 3/21/07 L.A. Times 3

2007 WLNR 5329127, quoting Bill Coleman, senior vice president of Salary.com: "This opens the door to other boards and compensation committees saying, 'Look at what happened at Blockbuster in March of 2007.'"

²¹¹ CEO Takes Stock In Firm's Future, 7/8/07 Ft. Worth Star-Telegram F1 2007 WLNR 12920554. Jim Keyes, the new CEO also had to make do without perks like country-club dues, car allowances, etc.

²¹² See Blockbuster Inc., Proxy Statement (Schedule 14A), at 55-56 (Dec. 13, 2006), available at http://google.brand.edgar-online.com/EFX_dll/EDGARpro.dll?FetchFilingHTML1?SessionID=RRRTWOqVF_ZMuNV&ID=5073909#DDE F14A_HTM_TX90974_49 ("The results of such a vote would... provide ...useful information about whether shareholders view the company's senior executive compensation, as reported each year, to be in shareholders' best interests.").

²¹³ See *id.* at 56. The opposing statement from the board of directors included the following:

The proponent's suggested "FOR" or "AGAINST" vote on selected portions of our annual executive compensation disclosures would not provide our Board with meaningful information about our stockholders' various viewpoints on complex executive compensation matters.

As recognized by the SEC's recent overhaul of companies' executive compensation disclosures, executive compensation policies, practices and determinations have become increasingly complex and must take into account a number of factors. We believe that the complexity and breadth of information that boards of directors and compensation committees consider and evaluate in connection with executive compensation decisions is fundamentally at odds with the proponent's suggestion of annually requesting a "For" or "Against" ratification on selected portions of our overall executive compensation disclosures. As a result, we believe that the proposal, even if implemented, would not provide our Board with meaningful input regarding

stated “[the proposals] are non-binding, so our board will take them under advisement,”²¹⁴ apparently unchastened by the message delivered by shareholders.

The actions of Blockbuster’s management and board might be indicative of non-internalization. Humiliation pressured behavioral modification, but it is unlikely to result in improvements to corporate governance practices unless there is some indication of internalization of the relevant norms. All the statements emanating from Blockbuster point to a reluctance to yield to the actions of norms entrepreneurs, suggesting that while they may have been successful in achieving desirable results in the short term, long term change might only come at greater cost.

C. Verizon

Verizon shareholders adopted a Say on Pay resolution by a vote of 50.18%, giving norms entrepreneurs one of their earliest successes.²¹⁵ In addition, 46% voted in favor of the “Golden Parachutes” proposal advocated by the AFL-CIO - purportedly aimed at loopholes in Verizon’s current policy for shareholder approval of golden parachutes.²¹⁶ The policy allowed shareholders to vote on severance agreements that exceed 2.99 times base salary plus bonus, but did not include retirement benefits, stock awards or tax reimbursements in that calculation.²¹⁷ The AFL-CIO proposal was geared at eliminating the possibility of severance

our stockholders’ various positions on complex executive compensation matters. Instead, we believe that the proposal creates a risk that the vote results may send an inaccurate or incomplete message to our Board, rather than communicating the actual and numerous viewpoints of our stockholders on particular aspects of our executive compensation program.

Id. (emphasis omitted).

²¹⁴ Moira Herbst, *Blockbuster Gives a “Say on Pay”*, BUS. WK., May 11, 2007, http://www.businessweek.com/bwdaily/dnflash/content/may2007/db20070511_961122.htm (quoting Angelika Torres, director of Blockbuster’s investor relations division); See also, http://blog.riskmetrics.com/2007/05/first_majority_for_say_on_pays.html.

²¹⁵ Verizon, 2006 Annual Report & 2007 Annual Meeting Materials, http://investor.verizon.com/financial/quarterly/annual_report.aspx (last visited February 19, 2008).

²¹⁶ Verizon Holders Pass Say-on-Pay Plan, Wall Street Journal, 5/19/2007, A3.

²¹⁷ See VERIZON COMM’NS INC., 2007 PROXY STATEMENT 14 (2007), available at http://investor.verizon.com/financial/quarterly/pdf/proxy_07.pdf.

[S]everance agreements as described in this resolution, commonly known as “golden parachutes”, are excessive in light of the high levels of compensation enjoyed by senior executives at the Company and U.S. corporations in general. The Institutional Shareholder Services (ISS) survey of 16 shareholder proposals to restrict golden parachutes in 2006 showed they averaged 51.2% of the vote and obtained majority support at six companies.

We believe that requiring shareholder approval of such agreements may have the beneficial effect of insulating the Board of Directors from manipulation in the event a senior executive’s employment must be terminated by the Company.

Id.

agreements being structured in order to take advantage of this loophole.²¹⁸ Another proposal requiring Verizon to disclose information pertaining to the assessment of the compensation consultants' independence failed narrowly after receiving 47% votes in favor.²¹⁹ The AFL-CIO also launched a campaign against members of the board who allegedly rewarded CEO Ivan G. Seidenberg with excessive compensation despite the company's stock underperforming.²²⁰

The evidence from Verizon shows the emergence of company-specific norms entrepreneurs. One such is the Association of BellTel Retirees, an organization representing 100,000 retirees from Verizon and predecessor companies such as Bell and Nynex.²²¹ This group owns about \$6,000 worth of Verizon stock, and has been orchestrating shareholder proposals for about ten years.²²² In 2004, it won shareholder approval for a proposal to limit executive severance packages to less than 2.99 times base salary and bonus, a measure that has echoes at other companies.²²³ If Verizon's board decides to go above that ceiling, it has to get approval from shareholders.²²⁴ In 2007, it targeted the CEO, Seidenberg's \$75.1 million in total expected compensation in the five years preceding 2005, as excessive because the return for shareholders over that period was minus 26.8%.²²⁵ The language used by this group leverages the power of a norm against greed:

²¹⁸ *See id.*

"Benefits" include lump-sum cash payments (including payments in lieu of medical and other benefits); the payment of any "gross-up" tax liability; the estimated present value of periodic retirement payments; any stock or option awards that are awarded under any severance agreement; any prior stock or option awards as to which the executive's access is accelerated under the severance agreement; fringe benefits; and consulting fees (including reimbursable expenses) to be paid to the executive.

Id.

²¹⁹ *Id.* at 16. They refer extensively to the work of Professor Bebchuk and in the supporting statement point out that: The *New York Times* reported that the independence of the Company's Consultant is open to question, revealing that the Company's Consultant provides other services for the Company. The article suggests that the Company's compensation consultant has a long and lucrative relationship with the Company, maintained at the behest of the executives whose pay it recommends.

Id. (citation omitted).

²²⁰ Tomoeh Murakami Tse, *AFL-CIO Goes After 6 Verizon Directors*, WASH. POST, Apr. 20, 2007, at D1, available at <http://www.washingtonpost.com/wp-dyn/content/article/2007/04/19/AR2007041902367.html?hpid=sec-business>.

²²¹ *See* Kim Leonard, *Verizon Retirees Seek Say on Pay*, PITTSBURGH TRIB.-REV., May 3, 2007, available at http://www.pittsburghlive.com/x/tribunereview/business/s_505838.html; M. Kennedy, *Getting a Say on Pay for Execs*, TIMES UNION (Albany, N.Y.), Apr. 20, 2007, available at <http://timesunion.com/AspStories/story.asp?storyID=582473&category=BUSINESS&newsdate=4/20/2007>.

²²² Leonard, *supra* note 224.

²²³ Kennedy, *supra* note 224.

²²⁴ *Id.*

²²⁵ *Id.*; *see also* SEC Info., Ass'n of Belltel Retirees, Verizon Commc'ns Inc., Notice of an Exempt Proxy Solicitation (Apr. 5, 2004), available at <http://www.secinfo.com/d157vj.1d.htm> ("It's no wonder that the widely-

“How many Verizon retirees – or Verizon shareholders – do you know with \$10 million, \$20 million, or \$30 million in ‘supplemental’ pension benefits? Please vote FOR this proposal to clamp down on this excessive and non-performance-based compensation.”²²⁶

D. Other examples

The AFL-CIO and the Connecticut Retirement Plans and Trust Funds attacked the \$83 million retirement package for Pfizer CEO Henry McKinnell before its annual meeting in 2007, and an investor group organized a “vote no” campaign.²²⁷ In accordance with recent practice, there was an attempt at pinning responsibility on members of the compensation committee who had approved the compensation agreement and two members of the company’s compensation committee received twenty-one percent withhold votes.²²⁸ In a show of ire at the SEC’s decision to allow Pfizer to leave out the AFL-CIO’s proposal seeking shareholder approval for supplemental executive retirement plans from the proxy, the AFL-CIO organized a rally at the company’s annual meeting with union members bearing “Give it back Hank” placards, in an attempt to embarrass the CEO.²²⁹ They even had an aircraft flying above, trailing similar messages.²³⁰

The Connecticut Retirement Funds adopted similar stances against nine other companies.²³¹ After news broke that the CEO of UnitedHealth held \$1.6 billion in unexercised stock options and had received options dated back to when company shares were at their quarterly lows, two institutional investors, the Minnesota Board of Investment, and CalPERS, stepped up their attack on the board and launched a campaign for withhold votes.²³² Despite a preemptive strike by the board on the eve of the annual meeting by announcing new compensation guidelines, the abrogation of golden parachute payments for senior executives, and the slashing of board compensation by 40%, two compensation committee members had to suffer the ignominy of seeing 28% withhold votes against their names.²³³

respected Corporate Library, in its 2003 governance rankings, ranked Verizon as one of the ‘ten worst’ among large U.S. companies, reporting that *‘the contracts and compensation policies for both Seidenberg and former co-CEO Lee contain virtually every example of excess and lack of control that could be found at a U.S. corporation, as well as a few that can be found nowhere else.’*”).

²²⁶ *Id.*

²²⁷ Brooke A. Masters, *A Campaign To Tighten Executive Pay*, WASH. POST, Apr. 28, 2006, at D1, available at <http://www.washingtonpost.com/wp-dyn/content/article/2006/04/27/AR2006042701901.html>.

²²⁸ Gretchen Morgenson, *Pfizer Shareholders Vote to Elect Directors but Show Concern Over Pay*, NY TIMES, April 28, 2006, available at <http://www.nytimes.com/2006/04/28/business/28pfizer.html>.

²²⁹ *Id.*

²³⁰ *Id.*

²³¹ INSTITUTIONAL SHAREHOLDER SERVICES, 2006 POSTSEASON REPORT: SPOTLIGHT ON EXECUTIVE PAY AND BOARD ACCOUNTABILITY 5 (2007), available at <http://www.issproxy.com/pdf/2006PostSeasonReportFINAL.pdf> [hereinafter ISS EXECUTIVE PAY REPORT].

²³² *Id.*

²³³ *Id.* “This level of investor opposition appears to be greater than what occurred last year at companies that faced criticism over pay practices. Among the notable withhold votes in 2005 against pay committee members were

The withhold votes phenomenon was to become widespread during the 2007 proxy season. Several companies including Exxon Mobil, Occidental Petroleum, Clear Channel Communications (31% withhold votes), Computer Associates (26%), and Home Depot saw their directors being targeted.²³⁴ Exxon saw over 20% withhold votes for some directors because of former CEO Lee Raymond's \$98.4 million retirement package.²³⁵ Ryland Group shareholders slapped a compensation committee member with a 34% withhold vote because of anger over supplemental retirement benefits for the CEO.²³⁶ Ill-timed option grants saw two compensation committee members at Michaels' Stores being hit with 25% withhold votes.²³⁷ M.D.C. Holdings saw shareholders react with a 17% withhold vote after controversial senior executive bonuses.²³⁸ The Utility Workers Union of America put forth a proposal targeting Exelon CEO John Rowe's 2006 compensation of \$16.4 million.²³⁹

The United Brotherhood of Carpenters and Joiners of America submitted proposals calling for "pay for superior performance."²⁴⁰ These were submitted to companies including Black & Decker, Weyerhaeuser, DuPont, and averaged 34.7% support at ten firms, an impressive achievement for a debut proposal.²⁴¹ This group has been active at several companies: at 3M, it submitted a proposal on executive compensation to be determined by benchmarking against peer companies, contending that the company's current compensation arrangements do not reflect the "pay for superior performance principle."²⁴² This was rebuffed by the management, claiming

Cendant (24 to 28 percent), Yahoo! (17 to 18 percent), Gillette (16 percent), and Morgan Stanley (14 percent)." *Id.* at 6.

²³⁴ *Id.*

²³⁵ *Id.* "This dissent was remarkable, given the oil giant's recent record earnings and that no director had received less than 96 percent support in more than a decade, according to news reports." *Id.*

²³⁶ *Id.* at 6.

²³⁷ *Id.*

²³⁸ *Id.*

²³⁹ See Brandon Glenn, Union Wants Exelon to Adopt "Say on Pay" Measure, ChicagoBusiness.com, Apr. 24, 2007, <http://www.chicagobusiness.com/cgi-bin/news.pl?id=26143&seenIt=1>; see also UWUA Proposal for 2008 Annual Meeting of Exelon Shareholders, <http://www.exelonpaywatch.org/> (last visited Mar. 5, 2008). The UWUA 2008 proxy proposal stated:

We believe executive compensation at our Company has become clearly excessive. For example, in 2006 Exelon awarded nearly \$35 million to only five top executives, including total compensation of \$16.4 million to CEO John Rowe.

This was significantly higher than top executive pay at comparable companies. For example, TXU Corp. awarded \$6.4 million less to its CEO, despite posting \$960 million more in net income. Indeed, in 2006 Mr. Rowe was the highest paid out of all chief executive officers in the 20 companies comprising the Philadelphia Utilities Index – collecting 73% more than the average of CEO pay in the entire index.

Id.

²⁴⁰ *Id.* at 21.

²⁴¹ *Id.* at 8.

²⁴² See 3M Co., Proxy Statement (Form 14A), at 28 (Mar. 26, 2007), available at <http://sec.edgar-online.com/2007/03/26/0001104659-07-022316/Section13.asp> [hereinafter 3M Proxy Statement].

such benchmarking was already being done.²⁴³ They also contended that “[s]enior executives are effectively motivated when their performance-based compensation is directly tied to 3M’s performance and not to the performance of ‘peer companies’ over which 3M’s senior executives have no control.”²⁴⁴

Resolutions sponsored by AFSCME aimed at giving shareholders an annual advisory vote on compensation committee reports received an average of about 40% support at Home Depot, US Bancorp, Countrywide Financial, and Merrill Lynch.²⁴⁵ The campaign relied on say on pay resolutions working well in the United Kingdom, and their “belie[f] that existing U.S. corporate governance arrangements, including SEC rules and stock exchange listing standards, do not provide stockholders with enough mechanisms for providing input to boards on senior executive compensation.”²⁴⁶ The response of Qwest’s board is remarkably typical:

[T]his proposal fails to recognize that stockholders already have a more efficient and meaningful method of communicating with our directors with respect to compensation and other issues, and that, in any case, the compensation program that we have established for our executive officers is thoughtful, performance-based, and in the best interest of our stockholders.²⁴⁷

The annual incentive or bonus component of the Plan should utilize defined financial performance criteria benchmarked against a disclosed peer group of companies, and provide that an annual bonus should be awarded only when the Company’s performance exceeds its peers’ median or mean performance on the selected financial criteria;

. . . The long-term compensation component of the Plan should utilize defined financial and/or stock price performance criteria benchmarked against a disclosed peer group of companies. Options, restricted shares, or other equity or non-equity compensation used in the Plan should be structured so that compensation is received only when the Company’s performance exceeds its peers’ median or mean performance on the selected financial and stock price performance criteria . . .

Id.

²⁴³ See 3M Co., Proxy Statement (Form 14A), at 2 (May 2, 2006), available at <http://www.secinfo.com/d11MXs.vt6a.htm>.

[W]here it has proven feasible to do so, the Company already makes a significant portion of its senior executives’ incentive compensation payable based on 3M’s performance as compared to that of other industrial companies. Fully 40% of the value of the 2005 awards under our 3-year Performance Unit Plan will be based on the extent to which 3M’s “Sales Growth” performance exceeds the Industrial Production Index (“IPI”) as published by the Federal Reserve;

. . . [T]he United Brotherhood proposal is too vague and unworkable to be applied at a diversified technology company like 3M.

Id.

²⁴⁴ 3M Proxy Statement, *supra* note 242.

²⁴⁵ ISS EXECUTIVE PAY REPORT, *supra* note 231, at 8.

²⁴⁶ Qwest Commc’ns Int’l Inc., Proxy Statement (Form 14A), at 63 (March 29, 2007), available at <http://sec.edgar-online.com/2007/03/29/0001193125-07-068840/Section20.asp>.

²⁴⁷ *Id.*

Like every other board that was hit with such a resolution, they claim “that direct communication between stockholders and the Board is a much more effective and accurate method of expressing support or criticism of our executive compensation practices.”²⁴⁸ The other standard response appears to be that “[a] stockholder vote would not be helpful in identifying any particular practice or issue that may be of concern to our stockholders.”²⁴⁹

Institutional Shareholder Services (“ISS”) reports that a total of 240 pay-related proposals were filed for annual meetings between January and May 2007, an increase from the 131 such proposals in the comparable period during the previous year.²⁵⁰ At the end of June 2007, CEO compensation proposals that sought to link pay with performance secured an average vote of 42.4% at twenty-nine annual meetings.²⁵¹ Eleven shareholder proposals related to executive pay have won majority support in 2007.²⁵² Six of these eleven resolutions were with regard to shareholder approval of golden parachutes, with Ryland shareholders leading the charge with 73% of the votes being in favor of the proposal.²⁵³ A proposal calling for performance-based restricted stock was carried by a 53.4% vote at JPMorgan Chase.²⁵⁴

The wave of activism is not restricted to left-leaning entities; the Amalgamated Bank sponsored a performance-based equity plan at Novellus and won 52% support.²⁵⁵ A similar proposal for performance-based options won 50.5% at Pulte Homes.²⁵⁶ At Lucent Technologies, there was majority backing for two pay-related proposals, relating to performance-based stock, and pension fund surplus.²⁵⁷ Professor Lucian Bebchuk’s proposals mandating disclosure of the estimated value of the benefits provided to top executives under any pension, deferred compensation plan, or supplemental retirement plan received 44.2% and 48.9% votes at Home Depot and El Paso respectively.²⁵⁸ ISS added to its benchmark voting guidelines by recommending voting against compensation committee members who were responsible for what it called “poor pay practices.”²⁵⁹ Pursuant to this approach, ISS recommended votes against directors at several companies, a phenomenon that can be expected to become more prevalent unless there is visible change in how directors approve compensation packages.²⁶⁰

²⁴⁸ *Id.*

²⁴⁹ *Id.*

²⁵⁰ <http://www.issproxy.com/pdf/SayOnPayWP.pdf>

²⁵¹ *Id.*

²⁵² ISS EXECUTIVE PAY REPORT, *supra* note 231, at 8.

²⁵³ *Id.*

²⁵⁴ *Id.*

²⁵⁵ *Id.*

²⁵⁶ *Id.*

²⁵⁷ *Id.*

²⁵⁸ *Id.*

²⁵⁹ *See id.*

²⁶⁰ *Id.* at 13.

Considering the infancy of the say on pay movement, it has been remarkably successful. Merck saw 49.2% of the votes being cast in favor of such a resolution.²⁶¹ At Morgan Stanley, 37% of the shareholders voted in favor over anger at John Mack, chairman and CEO, being paid a compensation package worth \$41.4 million last year, including \$36.2 million worth of restricted stock, and two other senior executives receiving over \$30 million.²⁶² The company had been at the center of a storm in the preceding years over the golden parachute awarded to the former CEO to the tune of \$52 million.²⁶³ This had prompted shareholders to pass a resolution requiring shareholder approval for golden parachutes.²⁶⁴ AFSCME moved a resolution for a nonbinding advisory vote on compensation.²⁶⁵ This was supported by ISS,²⁶⁶ but met with familiar objections from the board, including that such resolutions send unclear signals.²⁶⁷ It is baffling that the lack of clarity argument is frequently trotted out because it can be easily addressed. All that is needed is a multi-pronged vote that captures the various elements of the compensation package.

At Bank of New York, the resolution received 47% support (the CEO made \$14 million the previous year).²⁶⁸ Say on Pay majorities were achieved at Valero Energy and Ingersoll-Rand. However, despite repeated claims that the CEO is overpaid, shareholders at Countrywide only cast 31.7% of the votes in favor of a say on pay resolution.²⁶⁹ At JC Penney, the Bricklayers Union championed a resolution that asked the company to seek shareholder approval prior to severance packages that exceeded an executive's annual salary and bonus by a factor of 2.99.²⁷⁰

²⁶¹ Gretchen Morgenson, *Say-on-Pay Gets Support at Verizon*, NY Times, May 19, 2007, <http://www.nytimes.com/2007/05/19/technology/19verizon.html>.

²⁶² Tomoeh Murakami Tse, *Morgan Stanley, Bank of N.Y. Investors Reject 'Say on Pay'; Activist Shareholders Encouraged by Vote Totals*, WASH. POST, Apr. 11, 2007, at D1.

²⁶³ Joseph A. Giannone, *Shareholders Reject "Say on Pay,"* REUTERS, Apr. 10, 2007, <http://www.reuters.com/article/bankingfinancial-SP-A/idUSN1040609620070413?pageNumber=3>.

²⁶⁴ *Id.*

²⁶⁵ MORGAN STANLEY, 2006 PROXY STATEMENT 19 (2007), *available at* <http://www.issproxy.com/pdf/MorganStanley2007.pdf> ("The proponent believes that senior executive compensation at Morgan Stanley has not always been structured in ways that best serve shareholders' interests.").

²⁶⁶ *Id.* at 20 ("ISS believes that the advisory vote would allow shareholders a voice in executive compensation practices of a company. The advisory vote would be a confidence vote on the work of the compensation committee. ISS encourages companies to allow shareholders to express their opinions of executive compensation practices by establishing an annual referendum process.").

²⁶⁷ *Id.* at 19. ("The board believes that the proposed advisory vote would benefit neither the company nor its shareholders because it would not provide the compensation committee with any clear indication of the meaning of the vote. An advisory vote would not communicate shareholder views of the merits, limitations or preferred enhancements of our executive compensation. Instead, an advisory vote would require the Committee to speculate about the meaning of shareholder approval or disapproval.")

²⁶⁸ Giannone, *supra* note 263.

²⁶⁹ Martha Graybow, *Investors Not Sure They Want a 'Say on Pay,'* USA TODAY, June 13, 2007, *available at* http://www.usatoday.com/money/companies/management/2007-06-13-say-on-pay-proposals_N.htm.

²⁷⁰ Sam Pizzigati, *Soaring Executive Pay Attacked by Shareholder Activists*, CORP. WATCH, June 26, 2007, *available at*

Angered by a \$10.2 million severance package to an executive who had been employed by the company for six months, the shareholders passed the resolution.²⁷¹

In addition to taking action on a company-by-company basis, norms entrepreneurs have been at the forefront of regulatory activity by applying pressure at the early stages of drafting. In response to the SEC's proposed action on increasing disclosure of executive compensation, norms entrepreneurs were instrumental, at least in part, for the 23,000 comment letters received by the SEC.²⁷² They were also active in Congress during the passage of the Say on Pay Bill in the House.

Some norms entrepreneurs have sought to put forth standards of their own. For example, the Taft-Hartley unit has devised a compensation policy predicated on the total size of a CEO's total direct compensation ("TDC") awarded over the past year, the TDC percentage increase from the prior year, the company's cumulative stock performance over the past one, three, and five years, and the company's stock performance over the same time periods in relation to a peer group index.²⁷³ It recommended votes against directors at thirty-seven companies for compensation policies not reflecting a proper alignment of pay for performance under this model.²⁷⁴ This is a brilliant strategy for a norms entrepreneur: in the absence of clarity as to what constitutes an appropriate measure of performance, the ambiguity can be cleared up by norms entrepreneurs stepping into the informational vacuum and supplying relevant measures. To the extent these measures are followed by other market participants, norm creation is possible in accordance with the processes discussed. Over time, the norm could be internalized by the relevant actors.

There is also evidence of norms entrepreneurs creating networks by banding together over common causes: the AFSCME, and Walden Asset Management created networks to push resolutions for say on pay by bringing together public pension funds, labor funds, asset managers, foundations, and members of the Interfaith Center on Corporate Responsibility.²⁷⁵ Frequently, the objective behind the say on pay resolutions adopted by these norms entrepreneurs is to collectively shame the companies and their directors for allegedly excessive executive compensation, and networking facilitates the deployment of secondary sanctions.²⁷⁶

<http://72.14.253.104/search?q=cache:Ce75jx2iSQoJ:www.corpwatch.org/article.php%3Fid%3D14533+%22say+on+pay%22&hl=en&ct=clnk&cd=140&gl=us>.

²⁷¹ *Id.*

²⁷² *Id.* at 21 (As SEC Chairman Christopher Cox noted, "no issue in the 72 years of the commission's history has generated such interest.").

²⁷³ *Id.* at 24.

²⁷⁴ *Id.*

²⁷⁵ Anne Moore Odell, "Say on Pay" *Highlighted in the Upcoming 2007 Proxy Season*, SRI NEWS, Jan. 30, 2007, available at http://www.cbisonline.com/page.asp?id=187&sri_id=357 (quoting Timothy Smith, Senior Vice President of Walden Asset Management and President of the Social Investment Forum: "The vote will give investors an opportunity to send a message to the Compensation Committee about the scale of the compensation package as well as its link to performance. The other option unhappy investors have chosen in the past is voting against Directors serving on the compensation committee." (internal quotation marks omitted)).

²⁷⁶ See, e.g., Yaron Brook, *Should Shareholders Have a Say on Pay? – No*, INV. NEWS, May 21, 2007, available at

Non-traditional market participants are also taking on the role of norms entrepreneurs in the CEO pay debate. The Benedictine Sisters of the St. Scholastica Monastery, near San Antonio, entered the fray by filing a resolution at Coca Cola.²⁷⁷ Sister Susan, the director of corporate responsibility was quoted as saying, “CEO compensation has in many cases been excessive [w]e stepped up to file this resolution with Coke so that the board of directors and compensation committee will understand the importance of this issue both in terms of social responsibility and good business practice.”²⁷⁸

Given the sheer level of activity by such disparate groups, it is not surprising that the work of norms entrepreneurs is being noticed by companies. Rudiments of a cooperation norm are already emerging. One author writes that “Pfizer, Schering-Plough, Bristol-Myers Squibb, JPMorgan Chase, AIG, Colgate-Palmolive, Prudential Financial, Intel, and Tyco International agreed to join a working group with institutional investors to examine how U.S. companies can effectively implement a shareholder advisory vote.”²⁷⁹ This is nothing short of incredible and might be further evidence of network effects.

3. Reasons for the Success of Norms Entrepreneurs

Greed is a well recognized aspect of corporate life and some have described it as a norm.²⁸⁰ Norms entrepreneurs have successfully adopted social sanction strategies because of their realization that the old norm allowing greed is not internalized by a vast segment of the population. It is also against the message of most religions, and moral leaders, leading to widespread appeal. Given this disconnect between an alleged norm that purportedly allows some to be greedy, and the internalized values of the vast majority, it was inevitable that the “greed” norm would be challenged. One tactic appears to be the infliction of social sanctions like shame in order to assert the norm held by the majority and to displace the “greed” norm. As Moira Herbst notes:

[t]he point... is to make executives like Isdell a bit uncomfortable. Nuns, especially elderly ones who have dedicated their lives to humane works, have a moral vantage point available to few others. They’ll try to use that position this year at

<http://www.investmentnews.com/apps/pbcs.dll/article?AID=/20070521/FREE/70518005/-1/INIssueAlert04&ht> (“The ‘say on pay’ bill forces all corporations to allow shareholders a non-binding vote on CEO compensation. The idea is to shame directors into lowering chief executives’ pay, which the bill’s supporters claim is out of control.”).

²⁷⁷ See Moira Herbst, *Sisters on a Mission at Coke*, BUS. WK., Apr. 17, 2007, available at http://www.businessweek.com/bwdaily/dnflash/content/apr2007/db20070417_946151.htm. The Order only owns about \$25,000 in stock out of a total market capitalization of \$116.4 billion, and has no reasonable prospect of having its resolution carried. *Id.*

²⁷⁸ *Id.* (internal quotation marks omitted). Coca-Cola’s board, predictably, opposed the proposal: “We believe that more effective mechanisms are already available for the company’s shareowners to communicate concerns to the board about compensation or other matters.” *Id.* (internal quotation marks omitted).

²⁷⁹ *Id.* (citation omitted).

²⁸⁰ See, e.g., Kimberly D. Krawiec, *Accounting for Greed: Unraveling the Rogue Trader Mystery*, 79 OR. L. REV. 301, 329 (2000) (“The three most salient institutional norms that arise in the trading environment are greed, risk-taking, and independence.”).

Coke, as well as at Wal-Mart Stores, Delphi, and Caterpillar, on issues including global labor standards and the disparity between worker and executive compensation.²⁸¹

The stunted efforts of norms entrepreneurs appears to be having a tipping effect, aided no doubt by a bandwagon effect, as more institutional shareholders and small investors follow their lead and put forth similar proposals aimed at curtailing compensation. Politicians and other change agents facilitate tipping, and the creation of a new norm that correlates pay with performance. The result of so many actors campaigning for the establishment of the same norm is that it raises the stakes for companies and their boards to comply or face sanctions.

The work of norms entrepreneurs in creating corporate law norms is not unique to the case of CEO compensation or to the U.S.²⁸² Norms entrepreneurs have been active in other areas of corporate law. Writing about the need for norm change to achieve change in board diversity, one writer gives the example of the Alliance for Board Diversity, comprised of other organizations like Catalyst, the Executive Leadership Council, and the Hispanic Association for Corporate Responsibility, for the effectiveness of norms entrepreneurs.²⁸³ She cites CalPERS as a norm entrepreneur working for the greater inclusion of women and minorities on corporate boards.²⁸⁴ CalPERS has also had a marked influence on Japanese corporate law and public opinion.²⁸⁵ Thus, the examples considered above may be reflective of a broader phenomenon in corporate law.

²⁸¹ Herbst, *supra* note 277.

²⁸² One expert writes about the work of norms entrepreneurs in Japan: “[T]he evolution of Japanese norms on board role and structure can also be traced to the work of an identifiable norm entrepreneur. In 1997, Sony undertook significant board reform, shrinking the size of its board from thirty-eight to ten (seven executive and three outside directors) and introducing the executive officer . . . structure, which has no legal foundation under the Japanese Commercial Code. The seven executive directors and twenty-seven presidents of the various Sony companies comprise the executive officers. Sony’s reform, which was widely reported in the business and legal press, appears to have been a tipping point in board belief systems. Orix and other major firms quickly followed Sony’s extra-legal innovation. Within one year of Sony’s move, over 100 firms had adopted similar reforms. Within two years, the number of adopting firms approached 200.” Milhaupt, *supra* note 153, at 2117.

²⁸³ See Jayne W. Barnard, *More Women On Corporate Boards? Not So Fast*, 13 WM. & MARY J. WOMEN & L. 703, 719 (2007) (“The Alliance has as its mission ‘[making] the business case for inclusion on corporate boards through our belief that shareholder interests are best served by promoting the diversification of boardrooms within publicly traded U.S. companies.’” (citation omitted)).

²⁸⁴ *Id.* at 721.

²⁸⁵ See generally Sanford M. Jacoby, *Convergence By Design: The Case of CalPERS in Japan*, 55 AM. J. COMP. L. 239 (2007). (“It regularly appeared in the media while working closely with domestic norm entrepreneurs such as the JCGF and the PFA and indirectly with government ministries such as METI and HLW. The result of its labors are – at least in part – the various commercial code revisions consistent with positions originally espoused by CalPERS. They include provisions for online proxy voting, proxy access for major shareholders, stock options, share repurchases, independent board subcommittees, and acquisitions by foreign companies.”) *Id.* at 280.

4. *Tipping, Cascading, and Changing Equilibrium*

The febrile activity on CEO compensation is evocative of Malcom Gladwell's writings about epidemics.²⁸⁶ His theory is that these epidemics are transmitted "through social connections and energy and enthusiasm and personality."²⁸⁷ The current climate with regard to excessive CEO pay is very much like an epidemic. There is scarcely a day in the press without significant newsprint devoted to its coverage. The infectious agents in this context appear to be institutional shareholders, labor unions, and some activist shareholders, all profiting from an environment that favors the transmission of the epidemic.

Gladwell writes that the transmission process is served by "mavens" who take delight in learning a great deal about emerging norms and share that knowledge freely with others.²⁸⁸ This helps to transmit information widely at a low cost.²⁸⁹ He defines "connectors" as entrepreneurs merely by virtue of circumstance; they are placed in that position because of relationships and contacts with a wide variety of people.²⁹⁰ These connectors spread emerging norms widely simply because they "connect" to many different social groups and at many different levels.²⁹¹ Both mavens and connectors spread norms.²⁹² This is precisely what is transpiring currently in the CEO compensation area. There are "mavens" like Professor Bebchuk, connectors like Congressman Barney Frank, and norms entrepreneurs like ISS helping to make information accessible, and to create a climate for the arousal of outrage. In addition, the increasing income disparities in society create the climate for "infection" to spread and reach the scale of an "epidemic," ultimately implanting new norms.

The success of norms entrepreneurs is also aided in situations involving actors placing a high premium on reputation. Sunstein writes that people's concern for their reputations makes them "do what (they think) other group members think they should do."²⁹³ He points to the ever-growing desire for conformity in society as suggestive of the ways in which norms tip.²⁹⁴ According to him, "[t]he result of this process can be to produce snowball or cascade effects, as small or even large groups of people end up believing something – even if that something is false

²⁸⁶ MALCOLM GLADWELL, *THE TIPPING POINT: HOW LITTLE THINGS CAN MAKE A BIG DIFFERENCE* 18 (2000). ("[e]pidemics are a function of the people who transmit infectious agents, the infectious agent itself, and the environment in which the infectious agent is operating.")

²⁸⁷ *Id.* at 22.

²⁸⁸ *Id.* at 60-62.

²⁸⁹ *Id.* at 60-61. Norms entrepreneurs can fill the information gap when there is not enough or easily comprehensible information available in the community. They might have superior credibility, depending on who the norm entrepreneur is. See Dorothea Kübler, *On the Regulation of Social Norms*, 17 J.L. ECON. & ORG. 449, 453-54 (2001) (noting that the government enjoys such a superior position with respect to the control and management of relevant information).

²⁹⁰ GLADWELL, AT 38.

²⁹¹ *Id.*

²⁹² GLADWELL, *supra* note 2860, 255-56.

²⁹³ Sunstein, *supra* note 95, at 78.

²⁹⁴ *Id.*

– simply because other people seem to believe that it is true.”²⁹⁵ The occurrence of a cascade is conditional on the lack of much private information;²⁹⁶ the more confident people are about their own judgments, the less susceptible they are to outside influences. There can also be reputational cascades caused by people believing that they must engage in certain behaviors in order to protect their reputations.²⁹⁷ Sunstein writes that reputational cascades can result if “reputational considerations loom large” in the making of a given decision.²⁹⁸ In contrast, “[i]f people do not care about their reputations, or if reputation is a small component of the choice involved, the perceived intrinsic merits will be crucial, and cascades are unlikely to result.”²⁹⁹

Directors of boards are from sections of society that value their reputations intensely. Given that they are not the principal and direct beneficiaries of CEO greed, their concern for reputation makes them favorably disposed to the work of norms entrepreneurs in the compensation arena. While the greedy CEO can tradeoff a fat pay check in exchange for lowered reputation, directors are not paid enough for them to act similarly. Their compensation is primarily in terms of esteem. If this is undercut by the work of norms entrepreneurs, they might be incentivized to internalize a new norm.

The work of norms entrepreneurs in the examples provided above showing resolutions on say on pay might also give rise to a signaling equilibrium. The very act of proposing and canvassing of votes is costly and provides information about the shareholders of the company. If say on pay resolutions are carried, they might result in the creation of separating equilibria that allows firms to separate themselves from companies that do not have adequate restraints on excessive CEO pay.³⁰⁰ This could have a positive effect on the stock price if the market values such checks on CEO pay. The creation of such equilibria might explain the success of norms entrepreneurs.

²⁹⁵ *Id.* at 82 (“[R]eal-world phenomena also seem to have a great deal to do with cascade effects. Consider, for example, smoking, participating in protests, striking, rioting, buying stocks, choosing what to put on television, even leaving bad dinner parties.”).

²⁹⁶ *Id.* at 83.

²⁹⁷ *Id.* (“Suppose, for example, that *A* believes that hazardous waste dumps pose a serious environmental problem; suppose too that *B* is skeptical. *B* might keep quiet, or (like some of Asch’s subjects) even agree with *A*, simply in order to preserve *A*’s good opinion. *C* might see that *A* believes that hazardous waste dumps pose a serious problem and that *B* seems to agree with *A*; *C* might therefore voice agreement even though privately she is skeptical or ambivalent.”).

²⁹⁸ *Id.* at 84.

²⁹⁹ *Id.*

³⁰⁰ One author makes a similar point in respect of choice of law. See Edward M. Iacobucci, *Toward a Signaling Explanation of the Private Choice of Corporate Law*, 6 AM. L. & ECON. REV. 319, 336-37 (2004). The author recognizes that:

[I]f a pooling equilibrium emerges, in which all firms adopt the rule, establishing an option over a rule may not be socially useful. Both high- and low-quality firms, in order to appear of average expected quality, may adopt the rule. This would lead to social losses without any corresponding gains from the sorting of high- and low-quality firms. If such a pooling equilibrium were to emerge, a mandatory approach to a corporate law rule might be preferable.

Id.

To be sure, the catalytic role played by norms entrepreneurs was possible because their causes are aligned with the zeitgeist. As one author notes, “social change occurs for a complex variety of reasons. It is driven to some degree by the opinions and actions of influential people (role models), who precipitate change because they are widely noticed and imitated.”³⁰¹ Frequently, there is a bandwagon effect created by the working of norms entrepreneurs whereby momentum leads to individuals who do not have strong attitudes about the behavior in question being swept up to conform.³⁰² In the context of the corporate norm of greed, the social meaning of the behavior can be altered either by the work of norms entrepreneurs or by the government such that following the norm carries externalities, and the momentum built up pushes those on the fence towards conduct avoiding these externalities.³⁰³ This is particularly salient for directors, because they are not the direct beneficiaries of greed, but merely facilitate the greed of CEOs.

It would be folly to be too sanguine about the beneficial roles played by norms entrepreneurs. To be sure, some of the work will be undertaken by actors with particular political agendas not shared by the majority, for purely self-interested reasons. The possibility of people being victimized even if they have done nothing wrong exists.³⁰⁴ Unlike the case with legal sanctions, there is no processual check against this sort of political deployment of social sanctions that accompany asserted norm violations, and it would be a travesty if different directors were to be treated differently based on different interest groups deciding to mobilize social sanctions inconsistently. Interest-group capture is a realistic fear in the case of deploying shame sanctions against directors and CEOs. Trade unions and employee groups have a particular interest in curtailing CEO pay and these groups are getting increasingly more vocal in the proxy process. What is excessive pay to a left-wing trade union might not be so for many other market participants, and the deployment of shame sanctions based on political ideologies can be a threat to their efficacy.

IV. CONCLUSION

CEOs and directors are constrained by social norms to act with regard for the interests of their shareholders. Social sanctions present a low cost method to enforce these norms. The evidence considered in the preceding pages shows that norms entrepreneurs are working to establish norms including say on pay, the 2.99 multiple for severance payments, and majority voting for director election. These norms flesh out the well entrenched shareholder wealth maximization norm in corporate law. Norm creation is facilitated in corporate law because of the

³⁰¹ Peyton H. Young, *Social Norms and Economic Welfare*, 42 EUR. ECON. REV. 821, 829 (1998).

³⁰² Sunstein, *supra* note 322, at 968; *see also* Kübler, *supra* note 29289, at 454 (“A bandwagon norm is characterized by the property that once a critical number of norm followers is reached, the reputational value of a norm or the social pressure exercised by it increases sharply.”).

³⁰³ Kübler, *supra* note 29289, at 462 (“A certain norm-guided behavior can be discredited by advertisement campaigns or symbolic acts of influential people, thereby reducing the social pressure to follow the norm exercised by norm followers.”).

³⁰⁴ *See* Stephen M. Bainbridge, *The Case for Limited Shareholder Voting Rights*, 53 UCLA L. REV. 601, 625 (2006).

existence of groups where membership benefits are dependent on reputation. Unlike CEOs, board members are unable to tradeoff reputation for money because they are not paid enough. Since most directors seek board seats due to reputational payoffs rather than financial incentives, this enmeshment in groups presents advantages for the creation of useful norms for shareholders. Evidence indicates that norms can be created only when there is a sense of obligation. This sense of obligation results from internalization and socialization. The work of norms entrepreneurs is frequently to socialize relevant actors by imposing costs on them in terms of sanctions such as shame. If successful, internalization results in Pareto-self improvements with the relevant actors becoming “good types” by internalizing the norm. The example of Home Depot indicates the effect of internalization, and differences in behavioral modification based on internalization and non-internalization. While the new CEO appears to have internalized the norm, other board members resist the norm but modify their behavior due to the costs imposed by norms entrepreneurs. The examples of Blockbuster and Verizon illustrate the deleterious consequences for board members who choose to ignore the actions of norms entrepreneurs and resist the norm. Expulsion can result when norms entrepreneurs are successful in achieving tipping effects. Even where tipping is not possible, board members are subjected to shame and embarrassment by measures such as withholding votes. The power of such sanctions is evidenced by the behavioral modification that seems to follow in subsequent years in such companies. In the light of the preliminary evidence offered, it is clear that further empirical examination will offer useful insights into the role of norms in constraining CEO pay and correlating it to performance. Legislative attempts ought to be restricted to facilitating the application of social sanctions by creating conditions, primarily in terms of mandating the disclosure of relevant information in a comprehensible format. The law can also assist norms entrepreneurs by deploying its expressive power to reveal the popular consensus that CEO greed is unacceptable.