

SHAME SANCTIONS AND EXCESSIVE CEO PAY

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ABSTRACT

The debate over excessive CEO compensation has roiled scholars, corporations, and the government for some time. This article suggests that there is an alternate way of attacking the problem of excessive executive pay—one that sidesteps the law and instead appeals to executives' emotions. Shame sanctions, as they are called, offer a nonlegal route to curbing exorbitant CEO compensation. This article argues that increased disclosure of executives' compensation agreements will trigger emotions like shame, guilt and embarrassment by corporations and executives. This in turn has the potential to influence financial behavior and cause corporations to be more likely to heed the concerns of the public and shareholders vis-à-vis executive pay.

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I. INTRODUCTION

The debate over excessive chief executive officer (CEO) compensation has roiled scholars and policymakers for several years without either side being any closer to bridging the divide.¹ Perhaps owing to the growing influence of those who espouse greater regulatory oversight, and the disgust that highly inflated compensation agreements engender, the tide is finally turning through the actions of Congress² and the Securities and Exchange Commission (SEC).³ This article argues that a singular focus on regulation is mistaken, and contends that an approach based on nonlegal sanctions is the answer. Agencies like the New York Stock Exchange (NYSE) can resort to social sanctions with tools currently at their disposal at a relatively low cost to change the behavior of CEOs and corporate directors.⁴ That CEOs attempt to hide the true financial implications of their compensation packages for their companies,⁵ suggests that there are

¹See generally LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* (2004); Stephen M. Bainbridge, *Executive Compensation: Who Decides?*, 83 TEX. L. REV. 1615 (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).

²See Shareholder Vote on Executive Compensation Act, H.R. 1257, 110th Cong. § 2(h) (2007). In this proposal, shareholders would be allowed to cast non-binding votes regarding their approval or disapproval of executive compensation packages, which are now disclosed pursuant to the SEC's compensation disclosure rule.

³Executive Compensation Disclosure, Exchange Act Release Nos. 33-8765, 34-55009, 17 C.F.R. §§ 228-29 (Dec. 22, 2006), available at <http://www.sec.gov/rules/final/2006/33-8765.pdf>.

⁴One such tool is the NYSE's Corporate Governance Rules, section 13 of which provides that "[t]he NYSE may issue a public reprimand letter to any listed company that violates a NYSE listing standard." See Final NYSE Corporate Governance Rules, available at <http://www.nyse.com/pdfs/finalcorpgovrules.pdf>.

⁵*Empowering Shareholders on Executive Compensation: Hearing Before the H. Comm. on Fin. Svcs.*, 110th Cong. (Mar. 8, 2007) (written testimony submitted by Professor Lucian A. Bebchuk, William J. Friedman, and Alicia Townsend Friedman), available at http://www.house.gov/apps/list/hearing/financialsvcs_dem/htbechuk030807.pdf [hereinafter Written Testimony].

behavioral reasons for their conduct. This indicates that disclosure might produce beneficial results.⁶ It is revealing that corporations have stymied even the SEC's attempts to ensure that investors are informed about executive compensation agreements.⁷

The direct result of concealment is that investors make financial decisions without the benefit of crucial information, which fails to trigger emotions that might be useful to the law.⁸ Such emotions might motivate investors to react with outrage or anger and inflict social sanctions on greedy CEOs and corporate directors who fail to check their behavior. Social sanctions can include shaming, withholding of esteem, shunning, and negative voting by investors and other market participants. All of these have

"[P]ublic companies have consistently and persistently provided compensation in forms designed to make the amount of compensation, and the extent to which is [sic] was decoupled from performance, hidden or less transparent." *Id.* at 3. *See also* Lucian A. Bebchuk & Jesse M. Fried, *Pay Without Performance: Overview of the Issues*, 17 J. APP. CORP. FIN. 8, 17 (2005) ("[T]he information provided about deferred compensation arrangements does not allow even the most careful analyst to estimate with any precision the value conferred on executives through these arrangements.").

⁶Written Testimony, *supra* note 5, at 4 (noting that, the "SEC adopted rules requiring public companies to expand their disclosures on executive pay" in 2006). *See also* Peter H. Huang, *Regulating Irrational Exuberance and Anxiety in Securities Markets 2*, 35 (Univ. of Pa. Law Sch., Inst. for Law and Econ., Research Paper No. 03-34, 2003), available at <http://ssrn.com/abstract=474661> ("Mandatory disclosures generate not only information, but also such emotions as perhaps anxiety, embarrassment, euphoria, exuberance, feeling stupid, relief, or shame."). *Id.* at 35.

⁷The SEC Chairman said in a speech recently:

[W]e've reviewed the first of this year's crop, alarm bells are ringing. Already we're seeing examples of over-lawyering that are leading to 30- and 40-page long executive compensation sections in proxy statements. I have to report that we are disappointed with the lack of clarity in much of the narrative disclosure that's been filed with the SEC so far. Based on the early returns, the average Compensation Disclosure and Analysis section isn't anywhere close to plain English. In fact, according to objective third-party testing, most of it's as tough to read as a Ph.D. dissertation.

Christopher Cox, SEC Chairman, Closing Remarks to the Second Annual Corporate Governance Summit at the USC Marshall School of Business (Mar. 23, 2007), available at <http://www.sec.gov/news/speech/2007/spch032307cc.htm>. Cox also reported that "the median length for the CD&As was 5,472 words — over 1,000 words more than the U.S. Constitution. And the longest was more than 13,500 words . . ." *Id.* at 4.

⁸Behavioral economics research shows that emotions motivate people to punish opportunistic conduct. These studies indicate that subjects are more likely to inflict punishment when they are angry. There is also a demonstrable correlation between the degree of anger and the willingness to incur costs in order to punish offenders. *See* Ronald Bosman, & Frans van Winden, *Emotional Hazard in a Power-to-Take Experiment*, 112 ECON. J. 147, 148, 153-58 (2002); Dominique J.-F. de Quervain et al., *The Neural Basis of Altruistic Punishment*, 305 SCIENCE 1254, 1254-56 (2004). Studies involving participants interacting with other participants, all of whom have a certain amount of money, show that participants felt angrier the more money the other participant took, and were more concerned about fairness. *See* Madan M. Pillutla & J. Keith Murnighan, *Unfairness, Anger, and Spite: Emotional Rejections of Ultimatum Offers*, 68 ORG'L BEHAV. & HUM. DECISION PROCESSES 208, 217-19 (1996).

the potential to influence CEOs and corporate directors in positive ways.⁹ The determined efforts of corporations to keep the full amount of pay packages secret, suggests that concealment is aimed at preventing the levying of these social sanctions. If shaming is used as punishment, disclosure becomes even more potent, and rational actors will ensure they conform to the expressed social norm to avoid being shamed.¹⁰ If a shame sanction has been imposed, but conformity is not possible, the offender is likely to try to lessen the impact by being cooperative and expressing remorse.¹¹ It is also likely to yield to norm-internalization¹² and acceptance of the sanction, resulting in offenders becoming "good types" in the future.¹³ Norm-internalization in this context is not limited to the offender. Observers who would have been disposed to violate the norm in the future, might decide that the costs imposed on violators are not worth incurring and might

⁹Astrid Hopfensitz & Ernesto Reuben, *The Importance of Emotions for the Effectiveness of Social Punishment* 17-19 (Univ. of Amsterdam, Tinbergen Inst., Discussion Paper No. 2005-075/1, July 2005), available at <http://ssrn.com/abstract=775524> (suggesting that the willingness to punish has important implications for cooperative behavior). The authors explain:

[I]ndividuals who are willing to punish are also willing to keep on cooperating This guaranties that, as long as these individuals have the opportunity to punish, cooperation can be sustained. Furthermore this kind of individuals [sic] might help cooperation emerge, even if it was initially rare. In addition, the same type of people [sic] is necessary to support punishment in the presence of retaliation. If retaliation deters individuals from using the punishment mechanism, cooperation can unravel

Id. at 19.

¹⁰See Harrison Hong & Marcin Kacperczyk, *The Price of Sin: The Effects of Social Norms on Markets* 32 (Sauder Sch. of Bus. Working Paper, 2006), available at <http://ssrn.com/abstract=766465>. A study of "sin" stocks found that "there is a societal norm against funding operations that promote human vice and that some investors, particularly institutions subject to public scrutiny and social norms, pay a financial price for not holding these stocks." *Id.*

¹¹Alexander Dyck et al., *The Corporate Governance Role of the Media: Evidence from Russia* 5 (European Corporate Governance Inst., Fin. Working Paper No. 154, 2006), available at <http://ssrn.com/abstract=891206>. This study about corporate misconduct in Russia showed that:

in roughly half of the cases, media pressure leads a regulator or a politician to intervene, while in the remaining half, it is the company itself that relents, realizing the reputational costs of continuing the battle. In sum, this evidence suggests that the primary mechanism through which media coverage has an effect is by increasing the reputational cost of misbehavior vis-à-vis a relevant audience (in this case Anglo-American investors).

Id. at 5.

¹²Robert Cooter, *Expressive Law and Economics*, 27 J. LEGAL STUD. 585, 586 (1998). Professor Cooter defines norm-internalization as "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.*

¹³Renee M. Jones, *Law, Norms, and the Breakdown of the Board: Promoting Accountability in Corporate Governance*, 92 IOWA L. REV. 105, 150-51 (2006) (suggesting that mild punishments, instead of severe punishments, are more effective in inducing changes in behavior).

embrace the norm, or at least conform to it.¹⁴ There is some evidence of CEO compensation declining in the aftermath of shame-like sanctioning, suggesting that the model proposed here could be preferable to heavy-handed regulation.¹⁵

Aside from the harm that befalls investors in the form of lost welfare, hiding important information prevents shareholders from exercising vital oversight over boards of directors that may fall short of their fiduciary duties.¹⁶ If, indeed, CEOs and directors are motivated by emotions like shame and embarrassment, policymakers might benefit from intervention aimed at taking advantage of those emotions.¹⁷ Such interventions might obviate the need for expensive legal sanctions that must be invented if social sanctions can achieve similar results at a lower cost.¹⁸ Legal sanctions have also proven to be notoriously difficult to impose even where they already exist.¹⁹ By tapping into existing social sanctions, and leveraging their power to lower agency costs, the law can have a salutary effect without being heavy-handed and distortive.²⁰ I argue that emotions like shame and guilt

¹⁴*Id.*

¹⁵Randall S. Thomas & Kenneth J. Martin, *The Effect of Shareholder Proposals on Executive Compensation*, 67 U. CIN. L. REV. 1021, 1022-24 (1999).

¹⁶Bebchuk & Fried, *supra* note 5, at 17. The authors point out that:

the current omission of retirement benefits from standard compensation datasets has distorted investors' picture of pay arrangements. In particular, this omission has led to: 1) significant underestimations of the total amount of pay; 2) considerable distortions in comparisons among executive pay packages; and 3) substantial overestimations of the extent to which executive pay is linked to performance.

Id.

¹⁷Dyck et al., *supra* note 11, at 2. "Among the many tactics hedge funds [sic] managers use, the most prominent one is to focus public attention on an underperforming company and shame the CEO to either resign or change policy . . ." *Id.* See also Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control* 3 (European Corporate Governance Inst., Law Research Paper No. 06-16, 2006), available at <http://ssrn.com/abstract=919881> (explaining that hedge funds can serve as prominent shareholder activists).

¹⁸Abigail Barr, *Social Dilemmas and Shame-Based Sanctions: Experimental Results from Rural Zimbabwe* 3-5 (Univ. of Oxford, Ctr. for the Study of African Economies Working Paper No. 149, 2001), available at <http://www.csae.ox.ac.uk/workingpapers/pdfs/2001-11text.pdf> (explaining that shame-based sanctions could work just as effectively as fines). "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." *Id.* at 4.

¹⁹Jones, *supra* note 13, at 126.

²⁰Shyam Sunder, *Social Norms versus Standards of Accounting* 3-7 (Yale Int'l Ctr. for Fin. Working Paper No. 05-14, 2005), available at <http://ssrn.com/abstract=725821>.

Rule makers have little idea, ex ante, of the important consequences (e.g., the corporate cost of capital) of the alternatives they consider. Representations made to them by various constituents tend to follow predictable arguments that serve their respective self-interests, and do not enlighten the rule makers about the

have a role to play in influencing financial behavior, and that the scholarship on executive compensation can draw on insights from psychology and behavioral economics to advance our understanding of the methods of influencing CEO conduct.²¹ This helps to advance the scholarship beyond the hackneyed arguments about regulation that are routinely bandied about, and are often based purely upon severely stunted rational choice models.²² It also offers a third, contrarian approach to the problem of excessive CEO pay.²³ My thesis focuses on the role of shame and embarrassment in enforcing social norms against excessive CEO pay.²⁴ Given the fact that the emotions engendered by mandatory disclosures are by no means uniform, the fact that disclosures are structured in ways that are confusing and convoluted raises the level of emotional dissonance in the market.²⁵ This dissonance is expressed, for example, in the knee-jerk reactions visible when companies report that earnings must be restated, or when they do not expense stock options in compensation agreements, regardless of the actual financial implications for investors.²⁶ Clarity with regard to the total compensation paid to a CEO will help norms entrepreneurs²⁷ deploy social sanctions, such

consequences. Such arguments often turn out to be hollow posturing after the new rules are implemented.

Id. at 6.

²¹Huang, *supra* note 6, at 14. "Many of the cognitive psychological insights of behavioral finance were already an accepted part of the folk-wisdom that formed the basis and rationale for our federal system of securities regulation." *Id.*

²²Social sanctions like shame and ostracism might not work under the assumption of selfish utility maximization unless the offender values what other people think about him or her, because if she or he does not, she or he does not experience any loss in utility. See Amartya K. Sen, *Rational Fools: A Critique of the Behavioral Foundations of Economic Theory*, 6 PHIL. & PUB. AFF. 317, 335-56 (1977) (attacking the limitations of preferences in explaining conduct that shows that individuals do not always make personal welfare maximizing choices).

²³The first two approaches are: (1) more regulation, advanced by Bebchuk et al. and (2) laissez faire, advanced by Bainbridge et al. See, e.g., Bebchuk, *supra* note 1; Bainbridge, *supra* note 1.

²⁴It is well documented that social norms can play an important role in promoting cooperative behavior. See Ernst Fehr & Simon Gächter, *Cooperation and Punishment in Public Goods Experiments*, 90 AM. ECON. REV. 980, 984-93 (2000).

²⁵See Cox, *supra* note 7, at 9. Cox explained that:

GE's CEO actually made about \$1.7 million less in 2006 than was reported using the 123R number . . . [W]e discovered all of this on a Google search. But it took a little work. Today, there's not a good free website that links to this kind of information for many different companies, and that lets investors do this sort of math automatically.

Id. at 9.

²⁶Bill Saporito et al., *Wall Street's Verdict: While Washington Dithers on Reform, Investors are Pushing the Stock Market Down, Down, Down*, TIME MAG., July 29, 2002, at 18, 23-24 (reporting on investor anxiety from uncertainty over the cost of executive stock option grants).

²⁷Robert C. Ellickson, *The Evolution of Social Norms: A Perspective from the Legal Academy*, in SOCIAL NORMS 44, 44 (Michael Hechter & Karl-Dieter Opp eds., 2001). Professor Ellickson defines a "norm entrepreneur" as someone who "possess[es] a relatively high level of

as shame, to keep CEO compensation commensurate with performance. Better disclosure will also allow shareholders to determine if compensation is excessive, and to the extent that they think it is excessive, it will allow them to participate in sanctioning both the directors who approved the package, and the CEOs who demanded it. It also facilitates the creation of a norm that requires large institutional shareholders to engage in sanctioning behavior.²⁸ The creation of such a norm will minimize the free-rider problem by imposing costs on parties who choose not to pay the costs associated with enforcing the primary norm. Large institutional investors that do not sanction directors who approved inflated pay packages by shaming or removing them from the board, might also become targets of shaming by smaller investors and the broader financial community.

The enormous expense and inefficiency of attempts to regulate market manipulation should prompt investors and scholars to seriously examine the role of alternative sanctions like shaming.²⁹ While there has been attention devoted to shaming in other areas of the law, most particularly in criminal law,³⁰ corporate law scholars have only seemed to discuss shaming in passing.³¹ Given the financial and institutional costs imposed by legal sanctions, and the hostility of the market towards bearing such costs, shaming should be particularly attractive due to its low cost and decentralized enforcement potential.³² That much of the law on the fiduciary duties of boards of directors is morally driven should have occasioned a greater focus on shaming sanctions, because, at their very core, they are

technical knowledge relevant to the norms within [their] specialty" and is "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." *Id.*

²⁸Recent activism by institutional shareholders might be evidence of such behavior. See Gretchen Morgenson, *Investor Discontent Fills Annual Meeting Agendas*, N.Y. TIMES, Apr. 27, 2006, at C1.

²⁹See Lesley Wexler, *The International Deployment of Shame, Second-Best Responses, and Norm Entrepreneurship: The Campaign to Ban Landmines and the Landmine Treaty*, 20 ARIZ. J. INT'L & COMP. L. 561, 566 (2003).

³⁰Dan M. Kahan, *What Do Alternative Sanctions Mean?*, 63 U. CHI. L. REV. 591, 631 (1996); Dan M. Kahan & Eric A. Posner, *Shaming White-Collar Criminals: A Proposal for Reform of the Federal Sentencing Guidelines*, 42 J.L. & ECON. 365, 368-72 (1999); Dan Markel, *Are Shaming Punishments Beautifully Retributive? Retributivism and the Implications for the Alternative Sanctions Debate*, 54 VAND. L. REV. 2157, 2167-77 (2001); Toni M. Massaro, *Shame, Culture, and American Criminal Law*, 89 MICH. L. REV. 1880, 1883 (1991); James Q. Whitman, *What is Wrong with Inflicting Shame Sanctions?*, 107 YALE L.J. 1055, 1056 (1998).

³¹See 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, 261-62 (2004). The one notable exception is David A. Skeel, Jr., *Shaming in Corporate Law*, 149 U. PA. L. REV. 1811, 1812 (2001).

³²Wexler, *supra* note 29, at 564 (pointing out "[o]ne advantage of shaming penalties, as compared to incarceration, is their cheapness") (citing Note, *Shame, Stigma, and Crime, Evaluating the Efficacy of Shaming Sanctions in Criminal Law*, 116 HARV. L. REV. 2186, 2189 (2003)).

forms of moral disapprobation. The shortage of analysis on shaming involving CEO compensation is all the more curious given the increased use of rhetoric that invokes shaming-like language and tactics by market participants, most particularly by pension funds and other institutional shareholders.³³ Such rhetoric has also been deployed increasingly by norms entrepreneurs like Professor Lucian Bebchuk, and it is argued that the work of these scholars has a major role in the application of social sanctions.

Shaming, as it is used in this article, refers to a deliberate attempt to negatively impact a CEO or director's reputation by publicizing and targeting wrongful conduct occurring under their control.³⁴ This is to be distinguished from unintentional reputational damage that might be sustained by mere exposure from the news media or other agencies.³⁵ While this definition seems to be accepted by many legal scholars, Professor Jeffrie Murphy does not characterize these kinds of sanctions as shaming.³⁶ He distinguishes shame from humiliation, placing emphasis on the need for internalization in the former.³⁷

³³Siobhan Hughes & Kaja Whitehouse, *Labor Fights Verizon Board Over CEO's Compensation*, WALL ST. J., Apr. 6, 2007, at A3 (discussing the labor union's goal of removing Verizon directors who approved paying Verizon CEO Ivan Seidenburgh \$110 million in compensation over five years, when the company suffered losses). The article quotes AFL-CIO Secretary-Treasurer Richard Trumka as saying, "I defy anybody to say this guy's [sic] earned the money" and calling Verizon "the poster child for pay for pulse."

³⁴See Chad Flanders, *Shame and the Meanings of Punishment*, 55 CLEV. ST. L. REV. (forthcoming 2007), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=967521. "Although there is some disagreement about whether shaming punishments are properly named, most agree that shaming punishments involve the deliberate public humiliation of the offender." *Id.* at 2.

³⁵Shame should also be distinguished from guilt. According to some scholars, "[S]hame is related to a devaluation of the self, and therefore the action tendency of shame is withdrawal and avoidance of further contact. On the other hand, guilt is more related to the blameworthiness of an act and is thus more likely to result in reparation and action." See Hopfensitz & Reuben, *supra* note 9, at 21. Psychologist Donald L. Nathanson writes, "[G]uilt is the painful emotion triggered when we become aware that we have acted in a way to bring harm to another person or to violate some important code." DONALD L. NATHANSON, SHAME AND PRIDE 19 (1994). Philosopher Stephen Darwall writes, "One feels that one should *and could* have done what one didn't do, and feels appropriately blamed for that reason. And whereas guilt's characteristic expression is second-personal, shame *inhibits* second-personal engagement—one feels like escaping from view." Stephen Darwall, *Moral Obligation and Accountability* 5, in OXFORD STUDIES IN METAETHICS (Russ Shafer-Landau ed., 2007), available at <http://www.philosophy.ucr.edu/conference/Darwall-Obligation.pdf>.

³⁶Jeffrie G. Murphy, *Shame Creeps Through Guilt and Feels Like Retribution*, 18 LAW & PHIL. 327, 337-38 (1999). "I want to stress . . . that the arguments I shall here give in defense of moral shame should not be seen as offering even partial support for the currently trendy movement in American criminal law toward what are sometimes called 'shaming punishments.'" *Id.* at 337.

³⁷Professor Murphy's criticism is trenchant:

As practiced in America, these punishments (e.g., requiring prisoners to work on chain gangs or wear pink underwear or requiring convicted sex offenders to post

Professor Murphy's definition requires an internal element that he refers to as "moral shame" to distinguish it from "shame" as the term is employed here.³⁸ "Moral shame," then, refers "to a collision between one's actual self—past or present—and one's internalized and moral ego ideal."³⁹ Rather than dismissing the literature on shaming as Professor Murphy does, this article prefers to adopt a definition of shame that includes both facets. The actions of outsiders are aimed at instilling shame and can be characterized as the external element. One's own feelings of shame, either in response to the actions of others, or because of one's own conception of having fallen short of an ideal, can be characterized as the internal element. While shaming activity is possible without the internal dimension being present, both elements are necessary in order for it to be successful.

Shaming in the CEO compensation arena could be aimed at the following outcomes: labeling a CEO as excessively greedy, creating a reputation for a director as a "bad director," labeling directors as disloyal to shareholders' interests, excluding those disloyal directors from other boards,⁴⁰ causing economic harm to directors who approve excessive CEO compensation packages, and causing CEOs to be shunned by other corporations and commercial entities. The need for a society that has, at least, a minimum of shared beliefs and ideals is necessary if shaming is to have any power as a sanction. Shame sanctions are most effective in situations characterized by small, largely homogenous, and tightly-bound communities with many shared values.⁴¹ Regardless of differences in religion, ethnicity, education, goals, political affiliations, race, and gender, all shareholders share the belief that corporate assets must not be used to give windfalls to CEOs at their expense.⁴² Large shareholders, such as

notices of their crimes on their houses) have little or nothing to do with moral shame but rather strike me as mainly coercive exercises in humiliation and degradation—a kind of smug and mean spirited vengeance with tendencies to lapse into arbitrary cruelty. They do not engage and rebuild the core of the moral self but simply add extra punitive burdens and inconveniences (some of them quite grotesque) to the criminal's post-conviction life.

Id. at 337-38. It is unclear if Professor Murphy believes that humiliation does not require the internal aspect, although there is no reason to assume that it does not.

³⁸*Id.* at 338.

³⁹*Id.*

⁴⁰See Troy Wolverton, *AFL-CIO's Throw-the-Bum-Out Call Gets Cool Reception*, The Street.com (Sept. 26, 2003), <http://www.thestreet.com/stocks/troywolverton/10116076.html> (explaining a call by AFL-CIO for Kenneth Lagone, 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).

⁴¹Skeel, *supra* note 31, at 1811.

⁴²Some believe that shareholders are only motivated by the desire to make money. See JOHN R. NOFSINGER, *THE PSYCHOLOGY OF INVESTING*, at 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

institutional investors, are also likely to be part of an epistemic community.⁴³

A shared value requiring CEOs to work for the benefit of the company, and for directors to ensure that CEOs are adequately compensated, is sufficient for shaming to work. Shame can only play a role in constraining behavior if participants believe that bad behavior invites opprobrium, and therefore act in ways that are calculated to avoid shame.

A study of corporate conduct suggests that shame plays a role in constraining behavior. Evidence from empirical research will be considered in the following pages to understand the extent to which shame constrains behavior, and the ways in which it can be used to rein in CEO pay. Apart from being members of corporate boards, directors are part of several groups, like other corporate boards, clubs, and organizations. Interdependence and networking are indeed the very currency of the corporate boardroom. This enmeshment in groups presents conditions ripe for the deployment of shame sanctions. As will become apparent, for all but the most egregiously isolated director, shame will have some role in constraining conduct. Even for the most egregious anomaly, shame is not irrelevant because it shows that there is a cost, however small, associated with bad conduct. Even if the director or CEO is shameless, the very process of shaming has the effect of establishing and cementing the asserted norm—not a trivial function because it tells others who might become directors or CEOs that bad conduct invites shaming.⁴⁴ Thus, as long as reputation is not completely irrelevant, shame matters.⁴⁵ It is difficult to see how directors and CEOs of any company can be callous about their reputations. Indeed, it is most likely that these people are from the very sections of society that are most concerned with their reputations.⁴⁶ They have elections to win,

sophisticated, and human emotions are very complex. The emotions of fear and greed just don't adequately describe the psychology that affects people.

Id.

⁴³Peter M. Haas, *Introduction: Epistemic Communities and International Policy Coordination*, 46 INT'L ORG. 1, 3 (1992). Haas defines an epistemic community as a "network of professionals with recognized expertise and competence in a particular domain and an authoritative claim to policy-relevant knowledge within that domain or issue-area." *Id.* at 3.

⁴⁴See Kahan, *supra* note 30, 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.

⁴⁵Professor Kahan's widely reported recantation of his earlier views on shaming expressly rejects the argument that shaming is inappropriate because some offenders are shameless. Instead, he seems to be basing his recantation on the idea that shaming is partisan. See Dan M. Kahan, *What's Really Wrong with Shaming Sanctions*, 84 TEX. L. REV. 2075, 2076 (2006) ("What's really wrong with shaming penalties . . . is that they are deeply partisan: when society picks them, it picks sides, aligning itself with those who subscribe to norms that give pride of place to community and social differentiation rather than to individuality and equality.").

⁴⁶See Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability* 89 GEO. L.J. 797, 823 (2001) (hypothesizing that media coverage makes directors fear liability even more than they ought to). The

business deals to make, and careers to advance—all of which are founded on the possession of a good reputation. The stakes are much higher for these actors than they are for the average criminal, and shame, at least theoretically, must have a constraining effect on reputation conscious actors if they wish to be repeat players.⁴⁷ This might explain the hand-wringing that goes on within the director community when egregious violations are highlighted.⁴⁸ It has been frequently suggested that cases like *In re Walt Disney Company Derivative Litigation*⁴⁹ have the effect, apart from the facts and judgment of the court, of making directors more afraid and more conscious of their responsibilities, even if that case did not result in the imposition of liability.⁵⁰

Although directors get paid very little and perceive the risk of liability to be rather high, despite protestations to the contrary, there is no dearth of people who strive for positions on corporate boards. If compensation is not the primary motivation for board service, then considerations of prestige and esteem in society may be motivational factors for people coveting these appointments.⁵¹ Thus, sanctions like shame can be powerful constraints because they strike at the very root of the motivation for these individuals to want the good in question. If the risk of being shamed is rather high, these individuals might be constrained to act in ways that maximize shareholder interests and are seen to do so.⁵² To be sure, this constraint comes into conflict with the urge for self-preservation, since it is the CEO who

"hypothesis is that under certain predictable circumstances, executives will overestimate the risk of liability. There are a number of possible reasons. One is that newspapers and business periodicals highlight dramatic instances of such suits, and hence the threat of liability." *Id.* See also Alexander Dyck & Luigi Zingales, *The Corporate Governance Role of the Media*, in *THE RIGHT TO TELL: THE ROLE OF THE MASS MEDIA IN ECONOMIC DEVELOPMENT* 107, 109, 122 (2002) (expounding on the theory that corporate executives act appropriately because they do not want their reputations tarnished by negative media coverage).

⁴⁷Shaming will have a greater effect on corporate directors and CEOs because they generally hold their reputations in high regard as opposed to those who are not so concerned with the effects certain actions will have on their reputations. See, e.g., ELLIOT ARONSON, *THE SOCIAL ANIMAL* 186 (9th ed. 2004). Aronson explains that "individuals with the highest self-esteem experience the most dissonance when they behave in a stupid or cruel manner." *Id.*

⁴⁸Jonathan Macey, *Delaware: Home of the World's Most Expensive Raincoat*, 33 *HOFSTRA L. REV.* 1131, 1134 (2005) ("[Directors] do not like to be made the object of public scorn and ridicule.").

⁴⁹*In re Walt Disney Co. Derivative Litig. (Disney)*, 907 A.2d 693 (Del. Ch. 2005).

⁵⁰Martha Neil, *Disney Case Has No Storybook Ending*, A.B.A. J. *EREPORT*, Sept. 6, 2005, available at Westlaw, 4 No. 35 *ABAJEREP* 5 (asserting that the *Disney* decision will spur directors to be more attentive). The following words of the court have an ominous ring and might have served to send the message "that the Opinion may serve as guidance for future officers and directors—not only of The Walt Disney Company, but of other Delaware corporations." *Disney*, 907 A.2d at 698.

⁵¹Bebchuk & Fried, *supra* note 5, at 12. "Besides an attractive salary, a directorship is also likely to provide prestige and valuable business and social connections." *Id.*

⁵²*Id.* Professors Bebchuk and Fried note that directors "might have an incentive to develop reputations as shareholder-serving."

effectively determines if a person can become a director or stay on the board—actions that bring the director into conflict with the CEO are avoidable unless there are powerful incentives for taking those actions. Shaming might provide such an incentive.⁵³ Professor Bebchuk refers to "outrage costs" that directors have to bear when excessive compensation agreements are revealed.⁵⁴ Although he does not expressly refer to it, shaming appears to be at work in this context. When outrage is expressed, it is inevitable that some, if not all, directors will be shamed, either in the internal or external dimension. Faced with this choice, the director is caught between Scylla and Charybdis: if he or she ignores the deleterious effects for shareholders of an excessive compensation agreement and approves it, the director risks being subjected to a shaming sanction. If, on the other hand, the director voices objections to the agreement and votes against it, he or she will quickly be labeled a feisty director, and might not be welcome on other boards or even on the present one. This is certainly not ideal for individual directors, but it is hard to imagine why it might be bad for shareholders, except to the extent that it creates a shortage of good directors.

It is certainly true that the major reason people desire CEO positions are the financial incentives; shaming might be less effective when applied to these actors. This contrast might explain the different reactions of Richard Grasso and the board members of the NYSE to reports about the excessive compensation paid to him. Many directors who had approved the deal did a *volte-face*, while Grasso continued to maintain that he did nothing wrong.⁵⁵

This article will attempt to explore the linkages between shaming sanctions and excessive CEO compensation. In Part II, I provide a brief sketch of the scholarly treatment of shame sanctions in other areas of law and their role in strengthening social norms. In Part III, I focus on how shaming can be deployed in the CEO compensation arena. In doing the

⁵³*Id.* at 16. The authors explain:

[D]irectors and executives adopting such an [egregious compensation package] might bear social costs. Directors approving a clearly inflated and distorted pay package might be subject to ridicule or scorn in the media or in their social and business circles. Most directors would wish to avoid such treatment, even if their board positions were not at risk, and these potential social costs reinforce the constraints imposed by market forces.

Id.

⁵⁴Bebchuk & Fried, *supra* note 5, at 16. "The more outrage a compensation arrangement is expected to generate, the larger will be the potential economic and social costs, and thus the more reluctant directors will be to approve it and the more hesitant managers will be to propose it in the first place." *Id.*

⁵⁵Ben White, *Pay Raised Eyebrows Early On, NYSE Disagreed Over Grasso in '98*, WASH. POST, Feb. 3, 2005, at E03 (addressing the NYSE directors' concern about Grasso's compensation package).

above, I seek to make a contribution in moving the state of the scholarship beyond passing mentions of the role of social norms and shame sanctions in the CEO compensation arena. By providing a clear conceptual framework that identifies the relevant targets for the deployment of the shame sanction, the enforcers of the shame sanction, and the limitations of the sanction, I aim to open up new areas for the study of ways in which social sanctions can help curb excessive CEO compensation and promote shareholder interests.

II. SHAME: THE STATE OF THE SCHOLARSHIP

A. Arguments for Shaming

Shame has attained its height, in terms of scholarly treatment, in criminal law. It is described as "the process by which citizens publicly and self-consciously draw attention to the bad dispositions or actions of an offender, as a way of punishing him for having those dispositions or engaging in those actions."⁵⁶ Whether it is the publication of the names of patrons of prostitutes in newspapers,⁵⁷ or the requirement that people convicted of driving under the influence of alcohol or drugs display special license plates or bumper stickers,⁵⁸ the objective is the same—to reveal bad dispositions.⁵⁹ Shame works by harvesting the sense of moral disapproval

⁵⁶Kahan & Posner, *supra* note 30, at 368. See also Note, *Shame, Stigma, and Crime: Evaluating the Efficacy of Shaming Sanctions in Criminal Law*, 116 HARV. L. REV. 2186, 2187 (2003) (defining shame sanctions as "punishments that are directed primarily at publicizing an offender's illegal conduct in a way intended to reinforce the prevailing social norms that disapprove of such behavior and thus to induce an unpleasant emotional experience in the offender").

⁵⁷Stephen P. Garvey, *Can Shaming Punishments Educate?*, 65 U. CHI. L. REV. 733, 735 (1998) (discussing various shaming techniques used in criminal law); Courtney Guyton Persons, Note, *Sex in the Sunlight: The Effectiveness, Efficiency, Constitutionality, and Advisability of Publishing Names and Pictures of Prostitutes' Patrons*, 49 VAND. L. REV. 1525, 1526 (1996) (explaining that some cities have begun to expose the solicitors of prostitution through shaming practices).

⁵⁸Donna DiGiovanni, Comment, *The Bumper Sticker: The Innovation that Failed*, 22 NEW ENG. L. REV. 643, 644 (1988) (citing *Goldschmitt v. State*, 490 So. 2d 123 (Fla. Dist. Ct. App. 1986)).

⁵⁹Some reported cases where shaming has been employed are: *United States v. Gementera*, 379 F.3d 596, 609 (9th Cir. 2004) (affirming a decision requiring a convict to wear a signboard proclaiming his guilt); *United States v. Coenen*, 135 F.3d 938, 939 (5th Cir. 1998) (affirming a decision requiring a convicted sex offender to publish notice in the official journal of the parish, in addition to permitting his probation officer to require notice through signs, handbills, bumper stickers, clothing labels, and going door-to-door); *United States v. Schechter*, 13 F.3d 1117, 1119 (7th Cir. 1994) (affirming a decision requiring the convict to notify all future employers of his prior criminal tax offenses); *Goldschmitt v. State*, 490 So.2d 123, 124-25 (Fla. Dist. Ct. App. 1986) (affirming a decision requiring a defendant to place a sticker on his bumper reading: "CONVICTED DUI—RESTRICTED LICENSE"); *Ballenger v. State*, 210 Ga. App. 627, 628-29 (Ga. Ct. App. 1993) (imposing a condition requiring the offender to wear a fluorescent pink bracelet bearing the

felt by the community at the actions of the offender.⁶⁰ The enforcer is stepping into the shoes of the community as an organic entity, tapping into the sense of outrage and disapproval, and voicing it on behalf of the community.⁶¹ Frequently, the enforcer is presumptively acting on behalf of the community without any authorization for such action, basing the actions on a strange sense of self-confidence that the community is behind his or her actions.⁶² Such presumptive action sanctions conduct that is wrong and serves a signaling function that cautions bystanders to the serious loss of reputation that accompanies bad conduct.⁶³ Commonly, sanctions chill otherwise good conduct depending on the actor's tolerance for risk.⁶⁴ Ultimately, shame sanctions are aimed at deterrence.⁶⁵

Before his recent recantation, the principal exponent of shame sanctions in criminal law was Professor Dan Kahan.⁶⁶ Professor Kahan's views in support of shaming were tied to his belief in the expressive functions of criminal law—that society's expression of disapproval of criminal conduct is crucial if it is to be effective.⁶⁷ Professor Kahan argued that shame had the ability to express this disapproval better than incarceration, and was, therefore, preferable.⁶⁸ According to him, the serious harm to reputation serves both the deterrent and retributive objectives of criminal law.⁶⁹ Shaming is more attractive than incarceration because it does not come with the costs associated with the machinery that is needed for incarceration.⁷⁰ The task of enforcement is delegated to the community and the state does not have to spend money to carry out the sanction.⁷¹ Shame

words "DUI CONVICT").

⁶⁰Skeel, *supra* note 31, at 1816.

⁶¹*Id.* at 1814.

⁶²*Id.*

⁶³*Id.* 1814-15.

⁶⁴Skeel, *supra* note 31, at 1816.

⁶⁵This is at the root of such shame sanctions as wearing signs announcing the crime in public, requiring criminals to wear pink clothes in prison, and placing stickers on cars for drunk driving. *See Note, supra* note 56, at 2189-94.

⁶⁶Kahan, *supra* note 45, at 2075. Professor Kahan's recantation appears to be based on his belief that shaming is partisan, and that incarceration is preferable to shaming because it is "expressively overdetermined." *Id.* at 2076. Professor Kahan explains that "[a] law or policy can be said to be expressively overdetermined when it bears meanings sufficiently rich in nature and large in number to enable diverse cultural groups to find simultaneously affirmation of their values within it." *Id.* at 2085 (citing Donald Braman & Dan M. Kahan, *Overcoming the Fear of Guns, the Fear of Gun Control, and the Fear of Cultural Politics: Constructing a Better Gun Debate*, 55 EMORY L.J. 569 (2006)).

⁶⁷Kahan, *supra* note 30, at 594.

⁶⁸*See id.* at 592. *See also* Flanders, *supra* note 34, at 4 ("Compared to imprisonment, shaming punishments inflict much less physical cruelty. Indeed, they replace damage to one's physical integrity with mere damage to one's status or reputation.").

⁶⁹Kahan, *supra* note 30, at 630-49.

⁷⁰Kahan & Posner, *supra* note 30, at 371.

⁷¹Kahan, *supra* note 30, at 635-37.

might have supplementary advantages when deployed in conjunction with occasionally weak legal sanctions like penalties and fines, which may not be sufficiently effective in circumstances where the offender has vast economic resources.⁷² Reputation is perhaps the most significant attribute to such offenders, and therefore, when accompanied by a fine, a shame sanction can be an extremely effective tool.

Shaming meshes neatly with the CEO compensation debate because it does something that legal sanctions do not effectively accomplish. Legal sanctions are crude in their application—imprisonment and financial penalties do not serve to convey the emotions aroused by the actions of the offender.⁷³ Frequently, for most indirect, non-dangerous offenses, all that civilized society wants is for these emotions be ventilated, rather than to see the offender go to jail or that they be made to pay a fine. Addressing this concern is part of the law's expressive dimension.⁷⁴

In the CEO compensation case, one is not trying to get the CEO, who is excessively greedy, or the director, who does not exercise appropriate oversight over a compensation agreement, punished with the tools conventionally used to mete out legal punishment. Society recognizes that their conduct is not worthy of jail time, and that fines are crude matches for their actions. Legal sanctions, therefore, become inappropriate tools for what society really aims to accomplish. Any sanction, if it is to be meaningful and reflective of a sophisticated system, must match the message that society is trying to convey to the offender, and be proportional to the offense. Social sanctions, such as shaming, are more appropriate sanctions because they serve the expressive function of the law insofar as they tell the offender that they have acted in a way that warrants society's disapproval. It leaves other consequences to individual members of society to administer.

⁷²*Id.* at 619-20. This problem persists in most areas where fines are the punishment. For example, a fine would have been a rather weak sanction when applied to Martha Stewart because of her vast financial resources, whereas shaming can strike at a commodity that might not be so easily replaceable—reputation.

⁷³*Id.* at 621.

⁷⁴*See generally* Flanders, *supra* note 34, at 4. Flanders states: The law does not exist merely to allocate benefits and burdens; it also *says* things through its actions. . . . It is not as if society punishes by inflicting suffering and then stating in words that it does not approve of the offender's conduct. Rather, the punishment *is* the expression of condemnation: Society gives out harsh punishments for serious crimes because it wants to condemn those crimes in no uncertain terms.

Id.

B. *Arguments Against Shaming*

The scholarly community has not embraced this rosy view of shame sanctions. In fact it has been subjected to stunted attack as having debilitating negative effects.⁷⁵ One such effect is the formation of offender subcommunities that explicitly embrace their wrongs and defy the majority.⁷⁶ These subcommunities make it a virtue to engage in criminal activity and shaming will have no effect on them.⁷⁷ Criminal law scholars have pointed to the existence of gangs where criminal activity is celebrated rather than abhorred as examples of such subcommunities.⁷⁸ The other problem is that different offenders may be treated differently based on extraneous factors.⁷⁹ Professors Kahan and Posner provide the example of a gifted stockbroker who may not suffer in the long run from shaming for insider trading, but a run-of-the-mill broker may pay a heavier price.⁸⁰ The potential for treating offenders differently is not exclusive to shame sanctions, but is a cost borne by any punitive system. Critics of shame sanctions also contend that the purported cost-benefits of shaming are not as significant as the proponents would have us believe.⁸¹ The critics refer to the cost of establishing and maintaining a reputation, and explain that these expenditures may disappear when a reputation is tarnished without visible gain.⁸² Critics contend that shaming sanctions come with their own costs—namely the cost of engaging in the conduct engendering moral disapproval, whether it is forgoing otherwise profitable interactions, or the cost of conveying disapproval in another manner.⁸³ Professor David Skeel notes that cost is a factor that should be considered in the corporate context.⁸⁴

⁷⁵See generally MARTHA C. NUSSBAUM, *HIDING FROM HUMANITY: DISGUST, SHAME, AND THE LAW* (Princeton Univ. Press 2006) (discussing that shaming should be avoided in order to preserve human decency and individual identity); Garvey, *supra* note 57, at 739; Markel, *supra* note 30, at 2180; Toni M. Massaro, *The Meanings of Shame*, 3 PSYCHOL. PUB. POL'Y & L. 645, 683 (1997) (explaining that poor inner-city communities do not celebrate norm observation); Massaro, *supra* note 30, at 1935.

⁷⁶JOHN BRAITHWAITE, *CRIME, SHAME AND REINTEGRATION* 21 (1989). Braithwaite writes that "[offenders] associate with others who are perceived in some limited or total way as also at odds with mainstream standards." *Id.*

⁷⁷*Id.* at 4, 21.

⁷⁸*Id.*

⁷⁹Kahan & Posner, *supra* note 30, at 372.

⁸⁰*Id.*

⁸¹*Id.*

⁸²Massaro, *supra* note 30, at 1941.

⁸³Skeel, *supra* note 31, at 1819.

⁸⁴*Id.* at 1826. Professor Skeel explains:

[C]ost is a crucial variable in the corporate context because the relevant community—say, all shareholders of a large corporation—will frequently be far flung. Placing an advertisement in the Wall Street Journal to shame the directors

A slightly different and more substantive critique is offered by Professor Toni Massaro, who argues that shaming cannot work because of the lack of a coherent community in the United States.⁸⁵ She points out that the United States is not socially interdependent, and the heterogeneity in society creates problems of definition pertaining to the kinds of punishments that might engender a feeling of shame.⁸⁶ While there is some merit to this argument, it is by no means necessary for there to be a so-called "community" for shaming sanctions to work. It is sufficient that people share certain values or ideals with others, regardless of whether they belong to any kind of community that shares those values. It is certainly the case that most individuals share values and norms with others. To be sure, these common norms maybe few in number, and there is dispute as to what kinds of conduct falls under those norms, but no scholar seriously disputes their existence.⁸⁷ In the context of CEO compensation, the entire investing public shares the belief that directors and CEOs should not misapply corporate assets for their own benefit. This norm is the basis of our whole system of director liability. Further, the corporate director universe is extremely interdependent. Commercial and social linkages are so strong that no director can afford to ignore other actors without paying a very heavy price. This price can take the form of: lost business opportunities, withdrawal of job offers, flight of capital, collapse of company stock, the derision of peers, removal from other boards, and expulsion from social clubs and professional organizations. Professor Massaro's point about heterogeneity is even less problematic in the corporate context. Almost everyone participates in the market for profit, and most are likely to consider greedy behavior at their expense shameful. Even if the shareholders and the company's board do not regard the excessive compensation agreement as shameful, the very process of interacting with others who do, and make it known that they do, is likely to make all but the most thick-skinned directors feel some degree of shame and embarrassment. Thus, shaming will be an effective sanction for the

of Sears, for instance, cost Robert Monks well over \$100,000. Because of the high cost of placing such advertisements, enforcers' ability to attract national media attention, and thus free publicity of the shaming effort, dramatically enhances the likelihood that shaming will have an effect. Judicial enforcers do not face the same cost constraints since they can require the offending firm to bear the cost of the public shaming.

Id.

⁸⁵Massaro, *supra* note 30, at 1883-84.

⁸⁶*Id.* at 1923; Note, *supra* note 56, at 2194 ("Thus, even if a particular community could theoretically impose shame on an offender, a given judge's particular method of accomplishing that goal may still be off the mark.").

⁸⁷John C. Coffee, Jr., *Do Norms Matter? A Cross-Country Evaluation*, 149 U. PA. L. REV. 2151-54 (2001) (analyzing the differences in norms in multiple jurisdictions with similar legal systems).

rational actor who finds that the conduct has low utility.

Professor Martha Nussbaum offers a different critique in her book *Hiding from Humanity*, arguing that, as legal actors, one should abjure shame and disgust because they allow one to hide from one's humanity.⁸⁸ This is similar to Professor Massaro's contention that shaming penalties convey the message that "offenders subjected to these penalties are less than human others who deserve our contempt."⁸⁹ The dehumanizing aspect of shaming is also troubling to Chad Flanders, who writes, "shaming punishments involve the public in an exceptionally intimate way, and risk making punishment into an affair of the mob: where personal vengeance rules, instead of professional, bureaucratic impartiality."⁹⁰

Professor Nussbaum contends that shame and disgust are never constructive in law.⁹¹ In circumstances where disgust has salience, she argues that indignation is actually the preferable emotion.⁹² She seems to build her case on the idea that disgust is not an emotion that is the product of logic and rationality, or has a significant correlation with the harm that the offender causes, but that when one feels disgust, the usual reaction is to turn away or recoil from the issue rather than to deal with it effectively.⁹³ With regard to shame, Professor Nussbaum believes that it can spill over onto family members and associates of those who are shamed. This is not unique to social sanctions and can have beneficial consequences—the fear that imposition of the sanction will tarnish family members and associates creates strong incentives by pressuring the offender to conform to the law or norm. Such influence can begin during the very early years of an individual's life,

⁸⁸NUSSBAUM, *supra* note 75, at 7.

⁸⁹Massaro, *supra* note 75, at 699. Professor Massaro is further troubled by "the caste features of punishment" which are "jarring in a political order that makes equality a cultural baseline." *Id.* at 699-700.

⁹⁰Flanders, *supra* note 34, at 16. "Unlike imprisonment, shaming punishments require that citizens participate in degrading the offender: They require that citizens adopt certain negative attitudes towards the offender, in order that he literally *feels* society's disgust toward him. . . . Imprisonment puts punishment in the hands of disinterested professionals." *Id.*

⁹¹NUSSBAUM, *supra* note 75, at 231. "[I]n shaming people as deviant, the shamers set themselves up as a 'normal' class above the shamed, and thus divide society into ranks and hierarchies." *Id.* at 231-32. *But see* Peter H. Huang & Christopher J. Anderson, Review Essay, *A Psychology of Emotional Legal Decision Making: Revulsion and Saving Face in Legal Theory and Practice*, 90 MINN. L. REV. 1045, 1055 (2006) (reviewing Professor Nussbaum and critiquing her argument). Huang and Anderson contend that Professor Nussbaum's argument, taken alone, is "insufficient to convince the reader that it is necessary to purge disgust from legal and social thinking." *Id.* Instead, they "draw a different conclusion from the same information, which is that before disgust can be potentially useful, it must be actively managed." *Id.*

⁹²NUSSBAUM, *supra* note 75, at 75. Professor Nussbaum defines "indignation" as anger triggered by unfairness. *Id.*

⁹³*Id.* at 171. Professor Nussbaum finds disgust "unworthy of guiding public action" and "a dangerous social sentiment." *Id.*

with parents instilling values and morals with the objective of ensuring that the child does not grow up to become an offender. While seemingly conceding that point, Professor Nussbaum seems to focus more on the negative consequences of shaming innocent third parties without any corresponding deterrence benefits, which is a problem that is not unique to social sanctions. Professor Nussbaum's point about "hiding from humanity" might be well taken in the case of some crimes, but in the case of CEO greed, disgust is a constructive emotion. The modulation of emotions presents adequate checks against the potential to dehumanize because the enforcers of the sanction are institutions rather than the masses.

C. *The Internal Aspects of Shaming*

For shaming to work, the offender must internalize the norm that is allegedly violated.⁹⁴ As a result of such internalization, the offender must believe that his or her conduct has lowered him or herself either in his own eyes or in the eyes of people whose opinion he or she cares about.⁹⁵ In the absence of this internal aspect, it is hard to distinguish shame from mere losses or negative impacts on reputation. While losses or negative impacts on reputation can be suffered even when the offender does not believe that he or she has committed a wrong, it is probably true that he or she can only feel ashamed if the alleged wrong accords with norms that have been internalized. Only then will the offender feel a sense of shame when third parties find out about the wrong, which will in turn inspire a belief that those third parties think badly of him or her. Rather than feeling any remorse, if the offender gets angry after being the target of a shaming sanction, it is likely that the offender will react with an impulse to retaliate against those enforcing the sanction.⁹⁶ Confronted with retaliation, the enforcers, in turn,

⁹⁴Internalization 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, 904 (1998); Melvin A. Eisenberg, *Corporate Law and Social Norms*, 99 COLUM. L. REV. 1253, 1257-62 (1999).

⁹⁵Murphy, *supra* note 36, at 340. Professor Murphy states:

[T]o raise these kinds of questions—questions about the integrity and value of one's very self—just *is* to feel shame. In psychoanalytic language, these questions point to a conflict between what one is or has been and the image one has of one's ideal self, one's ego-ideal; and, if one's ego-ideal has moral values as constitutive elements, then at least certain moral failures will produce, not just guilt, but shame as well.

Id.

⁹⁶Hopfensitz & Reuben, *supra* note 9, at 16. The authors note:

The effect of anger becomes obvious once we examine the interaction of anger and shame. In this case, a clear result is obtained. Namely, second movers who were angry and felt no shame retaliate more and more frequently than second movers

might get angry and engage in a fresh round of punishment.⁹⁷ Thus, multiple rounds of sanctioning behavior can stem from anger at the primary sanction, leading to potentially debilitating social effects.⁹⁸ If, on the other hand, the offender experiences a sense of remorse, and internalizes the sanction, he is less likely to feel anger. This prevents anger-induced rounds of sanctioning behavior, and will make the punishment more effective.⁹⁹ Studies have shown that shame and guilt can prevent angry responses to punishment.¹⁰⁰ Curiously, one study showed that people who act unkindly are not immune from anger when they are punished for their unkindness.¹⁰¹ Only when they internalized the punishment and felt shame, did they desist from retaliatory behavior.¹⁰² Hopfensitz and Reuben made participants play the game twice and found that future kindness resulted only when punishment induced shame.¹⁰³ This presents interesting insights for

who were angry and felt shame For second movers who were not angry, there are no significant differences between those who felt no shame and those who did

Id.

⁹⁷*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. Nevertheless, this punishment institution is still effective for sustaining cooperation."). See also Nikos Nikiforakis, *Punishment and Counter-punishment in Public Good Games: Can We Still Govern Ourselves?* (Royal Holloway, Univ. of London, 2005) (examining the effect of counter-punishment on cooperation through the use of a public-good game experiment). Nikiforakis' experiment allowed two rounds of sanctions. *Id.* at 3. After the first round of sanctions, each participant knew the quantity of punishment points that each individual assigned to him. *Id.* The second round allowed 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 adequately sanction free-riders. *Id.*

⁹⁸Hopfensitz & Reuben, *supra* note 9, at 15 ("RESULT 2 – *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.*").

⁹⁹*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.").

¹⁰⁰*Id.* at 15 ("[S]econd movers who felt no shame are more likely to retaliate than other second movers. Furthermore, we also find that, for second movers who were punished, experiencing shame induces them to correct their behavior.").

¹⁰¹*Id.* at 19. Hopfensitz & Reuben discovered that:

Second movers who retaliate do so because they are angry and do not feel shame. In addition, following the feeling of shame, second movers rectify their opportunistic behavior. High intensities of anger are triggered by punishment, especially if the second mover had returned a positive amount. High intensities of shame are triggered by opportunistic behavior and are not affected by punishment.

Id.

¹⁰²Hopfensitz & Reuben, *supra* note 9, at 19.

¹⁰³*Id.* at 21. Their experiments showed the need for monetary punishments too: "[O]ur results indicate that, it is the combination of feeling shame and receiving monetary punishment that

sanctioning excessive CEO pay. If directors who approve the pay package do not believe that it is excessive, the imposition of a shame sanction is likely to make them angry. Shaming will only work once they realize that their actions are not in the interests of shareholders, because this realization will inspire the internal element of shame and will motivate them to act differently in the future. It is possible that they will change their actions even without understanding that the compensation package that they approved was excessive because, as rational actors, they realize the disutility that shaming sanctions create. Therefore, the sanction might make them angry, and they might believe that it was undeserved, but they may nevertheless modify their behavior. This is not the result of shame.

Can the offender feel shame if no one knows about the wrong? This is certainly possible, for most of our wrongs are only known to ourselves or to those closest to us. Yet, many of us feel shame even when the wrong is completely unknown.¹⁰⁴ There is a body of psychological research showing that people feel shame even when their offenses are hidden from others.¹⁰⁵ This is probably due to the sense of self that requires a certain moral compass, which makes one believe that by committing the wrong one has fallen short of that compass. One might also feel shame by imagining the response of others if they were to know of the wrong, although this feeling is likely to be fear rather than shame. What probably happens if one experiences shame, is that one feels that one has fallen short in one's own eyes. In the absence of this internal element, one would be able to categorize the reactions of others who try to inflict shame as motivated by ill will, malice, envy, jealousy, or some other emotion. After such categorization, it would be relatively easy to be unaffected by the attempts at shaming. If other people share this categorization, or can be persuaded to believe that no wrong has been committed, or that one's actions were justified in the circumstances, these attempts at shaming would have little or no power. Thus, the most important element in the shaming troika (offender, wrong, and audience) is clearly the offender. Shaming can work if there is no wrong, and if there is no audience, but it clearly cannot work if the offender does not internalize the norm. Despite this, Judge Richard Posner, along with other legal writers,¹⁰⁶ finds it sufficient that other people engage in

has a significant effect on behavior. This suggests that shame alone will not have an effect if the cooperative norm is not actively enforced." *Id.*

¹⁰⁴Some sociologists differentiate shame from guilt by the visibility of offense. If the offense is visible to others, under this view, shame is the appropriate emotion. If, on the other hand, the offense has not been observed by others, guilt is the appropriate emotion. See Eugene Kandel & Edward P. Lazear, *Peer Pressure and Partnerships*, 100 J. POL. ECON. 801, 806 (1992).

¹⁰⁵June Price Tangney et al., *Are Shame, Guilt, and Embarrassment Distinct Emotions?*, 70 J. PERSONALITY & SOC. PSYCHOL. 1256, 1257 (1996).

¹⁰⁶Ellickson, *supra* note 27, at 5 (pointing out that norms scholars continue to base their

deliberate attempts at shaming, thereby preferring to define shaming along purely the external dimension.¹⁰⁷ Although Judge Posner recognizes that shaming has two dimensions—that the offender will feel shame or guilt¹⁰⁸ (i.e., the internal aspect of shaming), and that it might trigger sanctions that third parties impose, such as cutting off relationships, terminating employment, and physical pain (i.e., the external aspect)—he focuses primarily on the second dimension. Judge Posner is certainly not alone in his emphasis on the role that bystanders play in enforcing norms by punishing norm-breakers through social sanctions such as dirty looks, disparaging remarks, ostracism, and the like.¹⁰⁹

The problem with auto-shame is that no wrong is necessary for it to occur. We frequently feel ashamed about the many stupid things that we say or do, although they may not in themselves be wrongs or offenses. The sense of shame that we feel in these contexts is often tied to our conception of the image we imagine we possess, and our feeling that our actions undermine or negatively impact that image. It is certainly possible that this image is a figment of our imaginations, and that we are indeed too foolish to realize that our actions do not cause a negative impact. Thus, there is no need to feel shame.

Judge Posner writes that one can feel shame even when the action does not violate an internalized norm.¹¹⁰ The examples he provides are

work on rational choice theory).

¹⁰⁷Richard A. Posner & Eric B. Rasmussen, *Creating and Enforcing Norms, with Special Reference to Sanctions*, 19 INT'L REV. L. & ECON. 369, 371 (1999). The authors explain:

We 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 other people take no action.

Id.

¹⁰⁸*Id.*

¹⁰⁹See, e.g., Lisa Bernstein, *Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 J. LEGAL STUD. 115, 116 (1992) (discussing the importance of reputational concerns in ensuring compliance with industry norms); Robert D. Cooter, Symposium, *Decentralized Law for a Complex Economy: The Structural Approach to Adjudicating the New Law Merchant*, 144 U. PA. L. REV. 1643, 1665, 1668-69 (1996) (suggesting third party enforcement is important in explaining emergence of norms); Eric A. Posner, *Law, Economics, and Inefficient Norms*, 144 U. PA. L. REV. 1697, 1699 (1996) ("[A] norm is like a law, except that a private person sanctions the violator of a norm, whereas a state actor sanctions the violator of a law."); Cass R. Sunstein, *Social Norms and Social Roles*, 96 COLUM. L. REV. 903, 915 (1996) (discussing norms as enforced through social sanctions).

¹¹⁰Posner & Rasmussen, *supra* note 107, at 371. Judge Posner & Professor Rasmussen explain that:

[o]ne can also be shamed (though the better word here would be "humiliated") for conduct that violates a moral code not one's own, where 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

actually examples of humiliation rather than shame.¹¹¹ Thus, 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.

D. *Processual Objections*

Some scholars have developed other critiques that focus on the lack of processual fairness in deploying shame sanctions.¹¹² The ready resort to shaming without due opportunity for the other side to adequately defend itself is a serious limitation that is hard to remedy. There is also something unsavory about trials in the media without the opportunity for cold reason and logic to be the primary means of discourse.¹¹³ Another problem is that shaming might go too far and succeed too much in punishing the alleged offender.¹¹⁴ It might also be that actors with particular political agendas that the majority does not share will engage in shaming, and people will be victimized even if they have done nothing wrong.¹¹⁵ Unlike the case with legal sanctions, there is nothing in the process to protect against this political deployment of shame sanctions. It would be a travesty if different directors were treated differently based on different interest groups deciding to use shame inconsistently. Interest group capture is a realistic fear in cases 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. A left-wing trade union's idea of excessive pay might be very different from that of many other market participants, making the deployment of shame sanctions based on political ideologies a threat to their efficacy.

felt no guilt at violating its norms.

Id.

¹¹¹*Id.*

¹¹²Seth F. Kreimer, *Sunlight, Secrets, and Scarlet Letters: The Tension Between Privacy and Disclosure in Constitutional Law*, 140 U. PA. L. REV. 1, 5-7, 9, 11-12 (1991).

¹¹³Whitman, *supra* note 30, at 1088 (worrying that shaming confers too much "enforcement power to a fickle and uncontrolled general populace").

¹¹⁴The suicide of a prosecutor who allegedly solicited a person he believed to be thirteen years of age following a Dateline NBC sting is a sobering reminder of the dangerous consequences of shaming. See Tim Eaton, *Prosecutor Kills Himself in Texas Raid Over Child Sex*, N.Y. TIMES, Nov. 7, 2006, at A10, available at <http://www.nytimes.com/2006/11/07/us/07pedophile.html?ex=1320555600&en=9a849fc4db0dzzzz28ce&ei=5088&partner=rssnyt&emc=rss>.

¹¹⁵Stephen M. Bainbridge, *The Case for Limited Shareholder Voting Rights*, 53 UCLA L. REV. 601, 635-636 n.89 (2006) (citing Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795, 825 (1993)).

E. *Shaming Overload*

Professor Massaro contends that the enormous scale of communications necessitated by the nature of the community would contribute to an "overload."¹¹⁶ If the number of instances of shame sanctions rise, inevitably there will be an increase in the number of people who might not participate in shaming. However, this does enhance the possibility of diluting the norm that shaming seeks to enforce. If, for example, the number of offenders wearing pink shirts were to become so common as to lose its potential for sticking out, it is unlikely that those wearing pink shirts will experience unpleasant attention from onlookers. This could lead to the very norm sought to be enforced losing its potency, and it could eventually lose its status as a norm. In the context of pink shirts, this is precisely what has transpired. Harel and Klement write that the loss of potency creates a dissonance

between the law's disapproval of the illegal act, and the willingness of individuals to overlook it. Increasing the rate of shaming may therefore fail not only in substituting for traditional sanctions' deterrent functions, but also in reinforcing community's cooperation with the law. Thus, an increased rate of shaming may paradoxically undermine the law's expressive value.¹¹⁷

They write that two models—a "Bounded Information Model" and a "Group Formation Model"—explain the decrease in effectiveness.¹¹⁸ According to the Bounded Information Model, as more offenders are shamed, it becomes harder for non-offenders to identify and isolate the offenders, with the result that the offender does not suffer the consequences of shaming.¹¹⁹ According

¹¹⁶Massaro, *supra* note 30, at 1930. See also Alon Harel & Alon Klement, *The Economics of Shame: Why More Shaming May Deter Less* 15 (Am. Law & Econ. Ass'n Annual Mtgs., 2005), available at <http://ssrn.com/abstract=789244> (analyzing the effectiveness of shame sanctions). Harel and Klement make a similar point:

[I]t is particularly important to notice that increasing the rate of detection decreases the deterrent effects of shaming since it increases the number of shamed individuals in the society and, as was shown earlier, such an increase decreases the expected costs of shaming due to the larger search costs it imposes on law-abiding individuals. Conflicting effects may of course outweigh this effect.

Id. at 15.

¹¹⁷Harel & Klement, *supra* note 116, at 21-22 ("Shaming penalties can be 'self destructive' as an extensive use of them may erode their effectiveness.").

¹¹⁸*Id.* at 22 n.38.

¹¹⁹*Id.*

to the Group Formation Model, which is similar to the point made about deviant subcommunities, an increase in the number of shamed offenders empowers these offenders to form groups, with the result that shaming is less effective.¹²⁰ They also write that "the more people shamed, the lesser the ability of law-abiding individuals to form law-abiding communities."¹²¹ This is curious given that it is inconceivable that more people will not be in the offender group at any given time than the law-abiding group. The proportion of the shamers to the shamed at all times must be quite high if the norm is to have any meaning. Otherwise, the norm will be deviance, rather than the conduct proscribed by the law.

These arguments about overload have some truth to them, but the problem of overload is not unique to shame. It could be argued that the enormous growth in the population over the last four decades, and the consequent increase in the number of offenders, has resulted in an overload of imprisonment. Further, the number of values or norms that characterize the relevant corporate community is rather small in comparison with the number of crimes that might exist in a national legal system. The fact that the number of possible offenders is limited to the number of directors and CEOs that exist at any given point in time, limits the possibility that the community is unable to identify the offender due to the overload. This overcomes some of the significant challenges that Professor Massaro points out about the nature of the community and the problem of identification.

III. SOCIAL NORMS AND SHAMING

Social sanctions can only serve as an effective means of achieving desirable conduct when they reinforce social norms or law.¹²² There is now a large body of literature on social norms¹²³ that sheds light on the expressive

¹²⁰*Id.*

¹²¹Harel & Klement, *supra* note 116, at 22 n.38.

¹²²*See generally* Dan M. Kahan, *Social Influence, Social Meaning, and Deterrence*, 83 VA. L. REV. 349 (1997) (arguing that society needs to create programs that promote lawful activities and denounce unlawful ones); Tracey L. Meares & Dan M. Kahan, *Law and (Norms of) Order in the Inner City*, 32 LAW & SOC'Y. REV. 805 (1998) (examining scholarly literature on criminal law policy dealing with social norms).

¹²³*See generally* Lawrence Lessig, *The Regulation of Social Meaning*, 62 U. CHI. L. REV. 943 (1995) & *The New Chicago School*, 27 J. LEGAL STUD. 661 (1998); 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); Sunstein, *supra* note 109. Due to the number of scholars at the University of Chicago doing this work, some have referred to it as the "New Chicago School."

dimensions of labeling conduct as pro-social or antisocial.¹²⁴ This scholarship could provide a rich vein of material for the issue of CEO compensation because the literature emphasizes the role of groups, and the participation of actors therein. Norms theorists argue, for instance, that law interacts with social norms by strengthening them to facilitate pro-social behavior. The paradigmatic example is the deployment of social norms by nonsmokers emboldened by the passage of laws against smoking in public areas to achieve compliance with the law in ways that are beyond what the legal system itself could achieve.¹²⁵ Scholars like Professor Cass Sunstein write that a change in the law can inspire a change in preferences.¹²⁶ He calls this the "expressive" function of law.¹²⁷ Norms theorists also focus on changes in social meaning that the legal system can cause, and the positive correlation that such signaling can have on pro-social behavior.¹²⁸ The principal example for this idea is the broken window theory.¹²⁹ This theory explains how 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.¹³⁰ Attaching a legal sanction to conduct can serve to engender displeasure and social condemnation. Specifically, entitling people to impose their own forms of sanctions against offenders conveys a message to potential offenders that social sanctions can exist apart from legal sanctions. While nonsmokers had, for a considerable

¹²⁴McAdams, *supra* note 123, at 341-43.

¹²⁵See Cooter, *supra* note 12, at 595.

¹²⁶See Cass R. Sunstein, *Endogenous Preferences*, *Environmental Law*, 22 J. LEGAL STUD. 217, 230-34 (1993).

¹²⁷Cass R. Sunstein, *On the Expressive Function of Law*, 144 U. PA. L. REV. 2021, 2022 (1996).

¹²⁸Kahan, *supra* note 122, at 352-53.

¹²⁹James Q. Wilson & George L. Kelling, *Broken Windows: The Police and Neighborhood Safety*, *ATLANTIC MONTHLY*, Mar. 1982, at 29; Meares & Kahan, *supra* note 122, at 822-23. Professors Meares and Kahan explain:

Order maintenance is likely to prevent crime through its effect on social influence. Social influence theory posits that individuals are more likely to commit crimes when they perceive that others are either engaged in or expecting crime. One of [sic] primary cues that crime *is* tolerated or expected is visible public disorder. . . . Order-maintenance policing can help to reverse these effects. When citizens obey norms of orderliness—and when authorities visibly respond to those who don't—onlookers see that the community does not tolerate criminality. This reverses the social influence effects.

Meares & Kahan, *supra* note 122, at 823. For a critique of this theory, see Bernard E. Harcourt & Jens Ludwig, *Broken Windows: New Evidence from New York City and a Five-City Social Experiment*, 73 U. CHI. L. REV. 271 (2006) ("Taken together, the evidence from New York City and from the five-city social experiment provides no support for a simple first-order disorder-crime relationship as hypothesized by Wilson and Keeling nor for the proposition that broken windows policing is the optimal use of scarce law enforcement resources.").

¹³⁰Meares & Kahan, *supra* note 122, at 823-24.

time, borne the costs of secondhand smoke, the passage of antismoking laws seems to make them much less tolerant of smokers.¹³¹ As a result, the antismoking measures work despite negligible legal enforcement.¹³² Thus, the law relies on this decentralized and privatized empowerment for its teeth.

Curiously, since the power of social norms seems to be at odds with rational self-interested behavior, the result is that social norms constrain people to give up otherwise self-interested actions.¹³³ Shaming and other social sanctions can only be effective in constraining excessive CEO pay if actors have internalized a norm against it. Behavioral economists have conducted several experiments showing that considerations of equity and fairness constrain subjects despite the opportunity to be greedy and self-regarding.¹³⁴ Several interesting problems crop up when one attempts to apply the social norms scholarship to the problem of runaway CEO pay. First, there exists the perpetual conflict between various social norms, each vying for primacy. *Aliter*, the social norm that greed is good, competes with another social norm favoring equity and correspondence between contribution and compensation. It is difficult to determine which norm should triumph. However, it must be recognized that a law defying a social norm by encouraging greed at all costs is likely to fail. Professor Robert Ellickson's famous study in Shasta County shows that the way in which neighboring ranchers allocate the costs of straying cattle is based on the community's norms and does not seem to be dependent on the law's allocation of these costs.¹³⁵ Professor Richard McAdams supports this view and argues that dissonance between law and social norms makes enforcing laws against antisocial conduct difficult.¹³⁶

Why, then are social norms so important? How is it that social norms are more powerful than positive law, backed up by the might of the state? One theory norms scholars offer pertains to the enormous value that people place in belonging to groups. If membership is so valuable, the argument is that people will go a long way to preserve that membership, and thus expulsion from the group serves as a powerful sanction. A pioneering study

¹³¹McAdams, *supra* note 123, at 404.

¹³²Professor Robert Cooter has written that although laws against smoking in public are almost never enforced, compliance is widespread, which suggests that labeling the behavior as a crime will heighten potential violators' fear of social sanctions, and might also encourage a real increase in social sanctions against violators. See Cooter, *supra* note 12, at 595.

¹³³See McAdams, *supra* note 123, at 340-41; Sunstein, *supra* note 109, at 911-12.

¹³⁴See Colin Camerer & Richard H. Thaler, *Anomalies: Ultimatums, Dictators and Manners*, 9 J. ECON. PERSP. 209, 216-18 (1995).

¹³⁵Robert C. Ellickson, *Law and Economics Discovers Social Norms*, 27 J. LEGAL STUD. 537, 540 (1998).

¹³⁶McAdams, *supra* note 123, at 349.

by Professor Lisa Bernstein focusing on the diamond industry showed that the persistence of industry customs can be explained by the value placed by members on belonging to the industry group.¹³⁷ This puts a lid on members' proclivities to attempt to gain advantages by short-term competitive behavior—based on the idea that these short-term benefits are smaller than those provided by membership in the group.¹³⁸

Another prominent theorist has proposed a model based on esteem—the underlying idea is that we value what other people think about us, and thus concede our unfettered autonomy by belonging to groups.¹³⁹ Professor McAdams bases his thesis on the idea that humans are social animals, and that acceptance by others is inherently important.¹⁴⁰ The core assumption of esteem theory is that people have a preference for something that others can give or withhold at zero cost: esteem.¹⁴¹ The assumption serves to avoid the collective action problem of norm enforcement. Because esteem is costless it is not subject to a free-rider problem. Although the preference for esteem is assumed to be slight, Professor McAdams shows that it can explain even very costly norm-guided behavior.¹⁴² It does not matter that other rewards flow from acceptance by others. If acceptance is its own reward, then people will behave in ways aimed at attaining acceptance, even in the absence of other rewards, and even in the presence of other costs.¹⁴³ Thus, 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, group membership may signal the type of person one is to onlookers.¹⁴⁴ By belonging to the Sierra Club, one may signal one's environmental friendliness, or by belonging to the National Rifle Association, one might signal one's endorsement of the right to bear arms. In many instances, the benefits of such membership far outweigh the costs of such signaling and people might join purely for that reason, regardless of whether they agree with the ideology of the group.¹⁴⁵ Some scholars give the example of voting as having a trivial benefit in terms of costs and benefits

¹³⁷Bernstein, *supra* note 109, at 157.

¹³⁸McAdams, *supra* note 123, at 355.

¹³⁹*Id.* at 355-57.

¹⁴⁰*Id.*

¹⁴¹*Id.* at 365.

¹⁴²McAdams, *supra* note 123, at 365.

¹⁴³A similar idea is contained in the peer-pressure based model of Kandel and Lazear. *See* Kandel & Lazear, *supra* note 104, at 816.

¹⁴⁴Eric A. Posner, *Symbols, Signals, and Social Norms in Politics and the Law*, 27 J. LEGAL STUD. 765, 766-67 (1998).

¹⁴⁵*Id.*

(the idea is that each individual vote may be worth little), but people vote because of the message it conveys that the voter is a responsible member of society.¹⁴⁶ 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.¹⁴⁷

Social norms do exist in corporate law.¹⁴⁸ Some scholars have pointed to the fact that despite the absence of clear legal standards and liability in many instances, corporate boards act in ways that are, at least facially, geared at ensuring that they act in the best interests of their shareholders.¹⁴⁹ Other writers claim that there is "compelling evidence that sin stocks are less held or followed by certain institutions and analysts who discriminate against sin stocks."¹⁵⁰ This sort of conduct can be explained by the operation of social sanctions.¹⁵¹ Scholars argue that actors do the right thing because of the fear of shame or embarrassment.¹⁵² Perhaps inevitably, such arguments lead them to espouse a minimal role for legal sanctions and courts.¹⁵³ Other corporate norms theorists dispute this thesis, expressing skepticism about the ability of social sanctions to be more effective than legal sanctions.¹⁵⁴ They contend that nonlegal sanctions are only a "weak constraint on opportunism within firms."¹⁵⁵ The nub of their argument appears to be that directors can be motivated to act appropriately by notions of altruism.¹⁵⁶ According to

¹⁴⁶*Id.* at 783-85.

¹⁴⁷Jeffrey J. Rachlinski, *The Limits of Social Norms*, 74 CHI.-KENT L. REV. 1537, 1548 (2000) (identifying possible flaws in the value of using social norms).

¹⁴⁸Edward B. Rock & Michael L. Wachter, Symposium, *Norms and Corporate Law*, 149 U. PA. L. REV. 1607, 1608 (2001).

¹⁴⁹See Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009, 1010-11 (1997); Lynn A. Stout, *In Praise of Procedure: An Economic and Behavioral Defense of Smith v. Van Gorkom and the Business Judgment Rule*, 96 NW. U. L. REV. 675, 683 (2002).

¹⁵⁰Hong & Kacperczyk, *supra* note 10, at 22. The authors explain:

Our findings on the effects of social norms in the context of the stock market strongly support the viewpoint that social norms can have important consequences for markets. Indeed, our results most likely represent lower bounds on the effects of social norms in the stock market, since many companies operating in sin industries may not become public precisely because they are shunned by many investors.

Id. at 6.

¹⁵¹See Eisenberg, *supra* note 94, at 1269-70.

¹⁵²See Rock, *supra* note 149, at 1013; Edward B. Rock & Michael L. Wachter, *Islands of Conscious Power: Law, Norms, and the Self-Governing Corporation*, 149 U. PA. L. REV. 1619, 1641 (2001); Skeel, *supra* note 31, at 1823-24.

¹⁵³Rock & Wachter, *supra* note 148, at 1666-67.

¹⁵⁴Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, 149 U. PA. L. REV. 1735, 1741-42 (2001).

¹⁵⁵*Id.* at 1796.

¹⁵⁶*Id.* at 1809-10.

them, the law can help to facilitate this "by articulating a social expectation that directors will exercise due care."¹⁵⁷ Courts perform an important framing function in their scheme.¹⁵⁸ The empirical support for this altruistic model appears to be founded on social dilemma studies demonstrating that individuals are not always selfish, but frequently engage in "other-regarding"¹⁵⁹ behavior even at a cost to themselves.¹⁶⁰ Scholars have even suggested that altruism might play a positive role in reining in excessive CEO compensation.¹⁶¹

There are interesting results from ultimatum games¹⁶² that might be instructive in the application of social norms to the CEO compensation area. Despite economic theory suggesting that the proposer should offer the lowest amount possible, and that the responder should accept that low amount on the understanding that something is better than nothing, experimental results show that the proposer usually offers a substantial part of the money, often half.¹⁶³ Experiments also show that if the proposer does not offer a substantial part, the responder frequently rejects the offer, knowing full well that he will get nothing.¹⁶⁴ This suggests that the proposer's desire to get as much of the money as possible is balanced by the fear that greedy action will invite rejection by the responder.¹⁶⁵ There may be lessons that can be drawn

¹⁵⁷*Id.* at 1744. Professors Blair and Stout write that "[w]hen the Delaware chancery court trumpets the importance of careful attention to fiduciary duties, directors and officers are likely to heed that call—even though they may have little or no external incentive for doing so." *Id.* at 1797.

¹⁵⁸Blair & Stout, *supra* note 154, at 1796. ("[C]ase law . . . can encourage corporate participants to internalize norms of cooperation through social framing—providing information about the social context of relationships within the firm.")

¹⁵⁹Lynn A. Stout, *On the Proper Motives of Directors (Or, Why You Don't Want to Invite Homo Economicus to Join Your Board)*, 28 DEL. J. CORP. L. 1, 9 (2003) (explaining other-regarding behavior as when "people behave as if they care about something other than their own payoffs").

¹⁶⁰*Id.* at 15. Professor Stout suggests that "directors might be inclined to behave in an other-regarding fashion simply because a respected authority asks them to do so."

¹⁶¹Michael B. Dorff, *Softening Pharaoh's Heart: Harnessing Altruistic Theory and Behavioral Law and Economics to Rein in Executive Salaries*, 51 BUFF. L. REV. 811, 815–19 (2003) (advocating the application of altruistic theory to resolve the problem of excessive executive compensation).

¹⁶²An ultimatum game features two players—a proposer and a responder. The proposer is given some money and told that he can offer any part of it to the responder. The responder has the choice of accepting or rejecting the offer. If he accepts, he gets what the proposer offered. If he rejects, both players gets nothing.

¹⁶³Camerer & Thaler, *supra* note 134, at 210; Martin A. Nowak et al., *Fairness Versus Reason in the Ultimatum Game*, 289 SCIENCE 1773 (2000).

¹⁶⁴Camerer & Thaler, *supra* note 134, at 210.

¹⁶⁵See Lynn A. Stout, *Other-Regarding Preferences and Social Norms 12* (Georgetown Law & Econ. Research Paper No. 265,902, Mar. 2001), available at <http://ssrn.com/abstract=265902>. Professor Stout explains:

[The results] suggest[] not only that people may have other-regarding preferences,

from these results. The responder's ability to reject, and thereby ensure that the proposer gets nothing, is key to the proposer's willingness to distribute a substantial part of the money in the first place. If shareholders are to be in the position of the responder, they have to have the ability to sanction the proposer (CEO) in the same way. A *sine qua non* for this to happen is that shareholders must know the exact details of the CEO compensation package, and be in a position to accept or reject it.¹⁶⁶ If all CEO compensation packages are subjected to shareholder approval, it is possible that ultimatum game results can be approximated. I doubt if they can be exactly duplicated because of the collective action problem. Professor Bebchuk argues that shareholder advisory votes on executive compensation would "express the collective judgment of the shareholders about the quality of the company's pay arrangements. An expression of widespread shareholder dissatisfaction would provide a valuable signal to the board. . . . [and publicity] would apply some pressure on the board to take the shareholders' preferences into account."¹⁶⁷ Even after the package has been approved, there is the possibility that bystanders can engage in sanctioning behavior.

A. *Is There a Social Norm Against Excessive CEO Pay?*

Professor Robert Cooter defines a social norm as conduct that society agrees people ought to engage in.¹⁶⁸ He writes that agreement about what

but that they know that *other* people may have other-regarding preferences. That possibility in turn suggests that other-regarding preferences influence human behavior at at least two levels.

At the first level, other-regarding preferences can cause some people to sacrifice to either help or to harm others around them. In other words, people who have other-regarding preferences will behave differently than they would if they were purely selfish.

At the second level, the knowledge that some people have other-regarding preferences will lead *other people* to alter their behavior in reliance upon this possibility—even if those others are themselves are purely selfish.

Id. at 12-13.

¹⁶⁶See Lucian Bebchuk, *Investors Must Have Power, Not Just Figures on Pay*, FIN. TIMES, July 28, 2006, available at <http://www.ft.com/cms/s/0/0d5b258e-1dd5-11db-bf06-0000779e2340.html>.

¹⁶⁷Written Testimony, *supra* note 5, at 4. Professor Bebchuk notes elsewhere that shareholder resolutions have been ignored. See Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 877 (2005).

¹⁶⁸Cooter, *supra* note 12, at 587. Professor Ellickson defines norms as rules of behavior that are enforced primarily by third parties other than state agents. See Ellickson, *supra* note 27, at 5. According to Judge Posner and Professor Rasmussen,

[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.

people ought to do is indicative of a possible social norm, but disagreement might be suggestive of a struggle to establish a social norm.¹⁶⁹ This, however, is not a sufficient condition for the establishment of a social norm.¹⁷⁰ Professor Cooter's formulation requires that the social norm be an "effective consensus obligation"—that is, people must not only agree that a social norm exists, but must act in accordance with that norm.¹⁷¹ He gives due attention to a somewhat neglected aspect of social norms—the internalization element—writing that people make a moral commitment when they internalize a social norm.¹⁷² Professor Cooter's emphasis on internalization is a richer formulation that contrasts with several other scholars who seem to be content to rely upon norms enforced by third parties without much regard for the impact on the offender beyond considerations such as negatively affected reputation. Their analysis is largely consequentialist in the sense that they are satisfied with conduct changing regardless of whether it is because the offender feels a sense of guilt or shame, or because he or she wants to minimize the costs associated with third party enforcement without feeling any sense of wrongfulness. In order for this to work, third parties must be willing to be the enforcers. They might be willing to pay this price, for example, under the Posner model, because they want to signal to potential partners that they are trustworthy "good types" to deal with.¹⁷³ Under the McAdams model, third parties would be enforcers because of the low costs associated with enforcement—they can bestow or withhold esteem at no personal cost.¹⁷⁴

Professor Cooter distinguishes between the consequences of internalization in cooperative and noncooperative settings, stating that internalization can be beneficial in the former.¹⁷⁵ It is precisely this scenario that occurs in the case of excessive CEO compensation. If CEOs structure their

Posner & Rasmussen, *supra* note 107, at 369.

¹⁶⁹Cooter, *supra* note 12, at 587.

¹⁷⁰*Id.*

¹⁷¹*Id.*

¹⁷²*Id.* at 586.

¹⁷³See ERIC A. POSNER, LAW AND SOCIAL NORMS 18 (2000) (explaining that "good types" are more likely to cooperate than "bad types" and therefore obtain mutual gains).

¹⁷⁴McAdams, *supra* note 123, at 355-75.

¹⁷⁵Cooter, *supra* note 12, at 587. See also McAdams, *supra* note 123, at 343-46 (emphasizing that people obey internalized norms even when they would suffer no legal consequences if they disobeyed them). Professor Cooter 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.

Cooter, *supra* note 12, at 587.

compensation agreements solely with the goal of receiving as much money as possible, regardless of their performance and length of service, it is inevitable that shareholders and regulators will work towards monitoring both compensation agreements and subsequent performance with greater vigor. This will divert resources away from more productive uses. While both shareholders and CEOs will bear these costs, it is probable that the CEOs will bear the brunt of them. This is due to the relatively large number of shareholders, which reduces individual costs for each shareholder. Further, this is also due to the fact that several egregious compensation agreements will be unraveled by the increased scrutiny. Thus, while the brilliant CEO will still command a high compensation package, the mediocre CEOs will suffer heavily because of this increased monitoring. Given this reality, all CEOs would be better off internalizing a social norm against excessive compensation and not being too greedy.

The crux of Professor Cooter's argument is that positive law can influence rational actors to change their character.¹⁷⁶ Thus, if a law sanctions CEO greed, it is likely that CEOs will be less greedy. Given the costs associated with this, Professor Cooter seems to imply that shaming can achieve the same result at a lower cost. If there is any possibility of publicizing egregiously high CEO pay, it is likely that CEOs will be less greedy since they will not want to appear as greedy. Curbing excessive CEO pay signals to shareholders that they can rely on the CEO to manage the company's assets in a manner most beneficial to shareholders. Excessive CEO pay, on the other hand, signals to shareholders that individuals holding CEO positions are not good participants in cooperative settings and that they are not good managers of the shareholders' assets. This can only work if the agreements are made public prior to their being signed, as the signaling has impact only before the CEO is hired. In many cases, the CEO may not be in the market for another job after he or she has become CEO of a particular company.¹⁷⁷ If, however, the information is released prior to hiring, and the shareholders decide that the demands are excessive, shareholders of other companies where this person may be a CEO candidate, will be signaled that he or she is not a "good type," negatively impacting the person's marketability. A law requiring disclosure of proposed pay prior to CEO hiring can influence the internalization of a norm against excessive pay. In the case of

¹⁷⁶Cooter, *supra* note 12, at 603-06.

¹⁷⁷Stout, *supra* note 165, at 20. Professor Stout explains:

[E]xternal 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.

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 in being appointed to other boards.

There is considerable evidence supporting the view that rational actors behave in ways that are other-regarding. The expectations of others appear to be a key determinant in several experimental studies.¹⁷⁸ These studies show that such expectations only play a role up to the point when they are in conflict with self-interest. An analysis of social dilemma games found that as the personal cost incurred by cooperating in a social dilemma rises, cooperation rates tended to fall.¹⁷⁹ Studies show that if a proposer offers a relatively larger share, the likelihood that the responder will spitefully reject it decreases.¹⁸⁰ Thus, people are only willing to be spiteful if the cost of being spiteful is not too high. While this is true for participants in the game, spite might be costless to observers, and they might step into the breach and engage in spiteful behavior to ensure that proposers are honest. Thus, while shareholders might evaluate the cost of spiteful behavior and conclude that it is too high, observers who are not shareholders in that corporation can engage in spiteful behavior at little or no cost. This can serve as a sufficient sanction for enforcing the social norm.

Creating a norm can only occur if people know about it and are aware of the sanctions that come with violation. This is where norm entrepreneurs have a powerful role to play. They are likely to be much more successful at creating norms than the state.¹⁸¹ It must be recognized that creating norms takes time—establishing a norm against CEO greed is not a day's task. Norms are creatures with a long gestation period, and acceptable conduct does not become unacceptable without conditioning. It is here that norm entrepreneurs can play a powerful role, frequently with the assistance of the law. The law can change the social meaning of conduct, and norms entrepreneurs can use this to create conducive circumstances for conditioning. Andreas Engert writes that norm creation is substantially facilitated by "network effects."¹⁸² According to him:

¹⁷⁸Stout, *supra* note 159, at 9-10.

¹⁷⁹David Sally, *Conversation and Cooperation in Social Dilemmas: A Meta-Analysis of Experiments from 1958 to 1992*, 7 RATIONALITY & SOC'Y 58, 75-79 (1995).

¹⁸⁰Stout, *supra* note 159, at 12.

¹⁸¹Posner & Rasmussen, *supra* note 107, at 379. Judge Posner & Professor Rasmussen make a similar point about nongovernmental organizations: "Nongovernmental 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." *Id.*

¹⁸²Andreas Engert, *Norms, Rationality, and Communication: A Reputation Theory of Social Norms* 10 (Aug. 2002), available at <http://ssrn.com/abstract=323020>.

"Heroes" may trigger the emergence of a new norm by incurring sacrifices. So

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.¹⁸³

B. *The Cost of Enforcing Social Sanctions*

To be sure, inflicting any kind of sanction is costly.¹⁸⁴ Even in the McAdams esteem model,¹⁸⁵ the very act of withholding esteem is not as costless as he suggests. The enforcer is not free from costs just because he or she only withholds esteem—this may cause a tear in existing friendships, for example. The enforcer of the sanction still has to pay a price, even when the sanction is relatively passive like shunning or avoiding the wrongdoer.¹⁸⁶

long as their endeavor is that of a few dispersed individuals their sacrifice 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. at 30-31.

¹⁸³*Id.* at 12-13.

¹⁸⁴See RICHARD A. POSNER, *THE ECONOMICS OF JUSTICE* 209-11 (1981); Doron Teichman, *Sex, Shame, and the Law: An Economic Perspective On Megan's Laws*, 42 HARV. J. ON LEGIS. 355, 363 (2005) ("In the context of [Sex Offender Registration and Notification Laws (SORNLS)], for example, these costs include setting up notification websites, updating these websites, tracking down offenders, and actively notifying communities."). Teichman further asserts that:

[n]on-legal sanctions are unique because through their use, the government can externalize some of the costs of sanctioning to the public. The amount of sanctions inflicted can therefore be raised without tapping into a limited government budget. Not only is this true of the cost of non-legal sanctions, which are quite obviously born by the sanctioning public, but is also true with respect to the costs of inducing non-legal sanctions.

Id. at 364 n.38.

¹⁸⁵The 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 13, at 144.

¹⁸⁶See Julia A. Houston, *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 SORNLS associated with their costs); Denise M. Bonilla & Joy L. Woodson, *Continuing Debate Over Megan's Law. Some Question Whether Sex Offender List Curbs Crime. The State Statute is Set to Expire Next Year*, L.A. TIMES, Feb. 14, 2003, at B2 (noting that registration verification would cost

There may be awkwardness experienced when the enforcer unintentionally comes into contact with the offender, or during a direct confrontation by the offender demanding to know why the enforcer is acting that way. Regardless of what the sanction is, there is little doubt that there is a cost, measured by the enforcer's position post-sanction relative to the enforcer's position pre-sanction. In many instances, this cost is only borne by the enforcer, whereas even the bystander who chooses to look the other way might benefit.¹⁸⁷ To be sure, there may be secondary benefits that may accrue to the enforcer. One secondary benefit might be the conveyance of an appearance of courage, integrity, and willingness to enforce the norm. This adds up to showing that the enforcer is a "good type." Some scholars characterize these parties as "shame-centered enforcers."¹⁸⁸ By showing that he or she is a "good type," the enforcer could also be trying to stave off a sanction against passivity that other enforcers might impose.¹⁸⁹ This sanction might take the form of the passive person being labeled a coward, being shunned as a person without a strong moral core, and so on. There are instances when people who do not participate in consumer boycotts have received various punishments, apparently exemplifying the fact that passivity may not always be costless.¹⁹⁰ This secondary sanctioning is an important component that is missing from the analysis of 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

the state \$15 million to \$20 million which is a "hefty request" given the California budget deficit).

¹⁸⁷See McAdams, *supra* note 123, at 352-53.

¹⁸⁸See Harel & Klement, *supra* note 116, at 5. They explain:

[Shame-centered enforcers] 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."

Id. at 5.

¹⁸⁹This is the idea behind the signaling theory postulated by Professor Eric Posner, whereby people are either "cooperators," who have a low discount rate, or "cheaters," who have a high discount rate. Cooperators and cheaters all play repeated games in which the former maximize their payoffs by interacting among themselves. To exclude cheaters, cooperators can use costly signals that only individuals who expect the high cooperative payoff can afford to send. The cost incurred by the sanctioning party is exactly what makes the infliction of the nonlegal sanction a credible signal. People who are passive are seen to be non-cooperators, and are excluded from profitable interactions with cooperators. See Posner, *supra* note 144, at 767-72.

¹⁹⁰See MONROE FRIEDMAN, CONSUMER BOYCOTTS AFFECTING 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 nonlegal sanctions); William Muraskin, *The Harlem Boycott of 1934: Black Nationalism and the Rise of Labor-Union Consciousness*, 13 LABOR HISTORY 361, 365 (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).

sanctions.¹⁹¹

This might suggest that enforcers must engage in a cost-benefit calculus, unless they are content to impose the sanction regardless of cost, perhaps for principle, altruism, or some similar reason. If such a calculation is inevitable, then the enforcer will quickly realize that several types of sanctions are possible, each with a different cost. If he or she chooses the shunning sanction, the cost is likely to be the opportunity cost of interacting with the offender, which itself varies with the unique attributes of the offender. If the offender is a close relative or friend, opportunities for interaction are likely to be frequent, and shunning might require more effort. If, on the other hand, the offender is a director who uses the same country club, shunning may not be terribly costly. If the enforcer chooses shaming, the cost is clearly greater than the cost of shunning. The enforcer has to undertake more positive actions such as spreading the word about the offender's bad conduct, with the increased risk of confrontation by the offender. The choice to impose any sanction is made in this way. The enforcer might conclude that he or she is willing to pay the price that shunning presents, but is unwilling to pay the price of shaming. In other words, shunning is more affordable than shaming.

If it is clear that all sanctions come with costs, we must delve into the reasons for enforcers being willing to bear that cost. Experiments conducted by behavioral economists show that people are frequently motivated to impose sanctions based on reciprocity. In other words, people want to do unto others as has been done to them. Results from ultimatum games have shown that people are willing to pay a monetary cost to punish people who have treated them in ways that they perceive to be deserving of punishment.¹⁹² Reciprocity, in turn, seems to allow participants in repeated

¹⁹¹Laurent Denant-Boemont et al., *Punishment, Counterpunishment and Sanction Enforcement in a Social Dilemma Experiment*, 33 *ECON. THEORY* (forthcoming 2008), available at <http://userwww.service.emory.edu/~cnoussa/index.html> ("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.").

¹⁹²Werner Güth, et al., *An Experimental Analysis of Ultimatum Bargaining*, 3 *J. ECON. BEHAV. & ORG.* 367, 382 (1982). See generally RICHARD H. THALER, *THE WINNER'S CURSE* 21-35 (1992) (explaining the ultimatum game theory in its various forms, the simple ultimatum game, two-stage bargaining games, multi-stage games and their economic implications, and discussing that in an effort to punish the offeror, the offeree may reject an offer he perceives to be unfair because the offeror is overcompensated); Ernst Fehr & Armin Falk, *Psychological Foundations of Incentives*, 46 *EURO. ECON. REV.* 687, 689-704 (2002) (explaining that nonpecuniary motives influence behavior); Werner Güth, *On Ultimatum Bargaining Experiments—A Personal Review*, 27 *J. ECON. BEHAV. & ORG.* 329 (1995) (reviewing ultimatum bargaining experiments and discussing the difference between rational choice explanations and behavioral explanations in ultimatum games).

games to maximize their personal payoffs.¹⁹³ While reciprocity in bilateral situations seems intuitive enough, what is interesting for our purposes is the evidence suggesting that reciprocity seems to be transferable—people view injustices perpetrated on others as if they had been perpetrated on themselves, and punish the offender.¹⁹⁴ One example is the anti-Nazi boycotts during World War II.¹⁹⁵ Thus, investors might be willing to sanction greedy CEOs and directors who approved their compensation packages regardless of the fact that they do not own shares in the corporations which lost money because of these agreements. It suffices that other shareholders were treated badly by these CEOs and directors.

C. The Role of Norm Entrepreneurs and Change Agents

The development and enforcement of social norms depends upon the actions of norms entrepreneurs and change agents. In one scholar's view, "[c]hange agents are low-cost suppliers of new norms."¹⁹⁶ They can do this because they are uniquely privileged by technical knowledge, and leadership skills allow them to bear the opportunity costs of norm reform.¹⁹⁷ Professor Ellickson defines a "norm entrepreneur" as someone who "possess[es] a relatively high level of technical knowledge relevant to the norms within [their] specialty" and is "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."¹⁹⁸ There are several examples of norms entrepreneurs resorting to shaming techniques to enforce social norms. For example, Bill Browder, the Chairman of the Hermitage Fund has been quoted as saying:

Our basic approach is to thoroughly research and understand where the corporate malfeasance is taking place and then go to

¹⁹³ROBERT AXELROD, *THE EVOLUTION OF COOPERATION* 27-54 (1984) (showing how a reciprocal strategy can lead to higher payoffs for a player in a repeated prisoners' dilemma).

¹⁹⁴Daniel Kahneman et al., *Fairness and the Assumptions of Economics*, 59 J. OF BUS. S285, S290-S292 (1986). The results of the experiment were clear—74% of the players in the second round chose to sacrifice their monetary well-being in order to sanction individuals that treated *other* players unfairly.

¹⁹⁵William Orbach, *Shattering the Shackles of Powerlessness: The Debate Surrounding the Anti-Nazi Boycott of 1933-41*, 2 MOD. JUDAISM 149, 161-66 (1982).

¹⁹⁶Curtis J. Milhaupt, *Creative Norm Destruction: The Evolution of Nonlegal Rules in Japanese Corporate Governance*, 149 U. PA. L. REV. 2083, 2112 (2001) (giving the example of M&A Consulting, Inc.'s CEO, Yoshiaki Murakami's hostile bid for Shoei Corporation in Japanese corporate law).

¹⁹⁷*Id.* at 2112-13.

¹⁹⁸Ellickson, *supra* note 27, at 19.

great pains to simplify the story so the average person can understand what is going on. . . . We then share the stories with the press. By doing so, we want to inflict real consequences—business, reputational and financial.¹⁹⁹

Norm entrepreneurs like the Hermitage Fund also resort to the legal system to advance their cause. They rely on the publicity generated by the filing of a lawsuit alleging a corporate governance violation to shame the company.²⁰⁰ Professor Bebchuk has emerged as a dominant norm entrepreneur in the CEO compensation area. He possesses technical expertise, and has engaged in a sustained campaign aimed at increasing shareholder power, primarily by writing and speaking prolifically on the topic.²⁰¹ Norms entrepreneurs have been remarkably active during the last few years in the CEO compensation area. Their success is evidenced by the fact that the 2006 proxy season was witness to 23.9% of shareholder proposals being focused on executive compensation.²⁰² Recently, the American Federation of State, Country, and Municipal Employees sponsored proposals at several corporations aimed at giving shareholders an advisory vote on executive compensation. The proposals remarkably secured 37% and 47% favorable votes at Morgan Stanley and Bank of America, respectively.²⁰³

There has been a slew of rulemaking by regulatory bodies in an

¹⁹⁹Dyck et al., *supra* note 11, at 3. The authors also found that "the presence of the Hermitage fund among its shareholders increases the amount of coverage a corporate governance violation receives." *Id.* at 4.

²⁰⁰*Id.* at 9-10. Bill Browder, Chairman of the Hermitage Fund, elaborated further: We've been involved in 32 lawsuits. And we win in terms of public attention regardless of the outcome, where we've lost 31 times. I think the proportion of number of words written in the press when a lawsuit is initiated to when it is dismissed is 50 to 1. The court of public opinion is much more effective than the Russian legal system and much fairer.

Id. at 16.

²⁰¹*See, e.g.*, 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 A. Bebchuk & Yaniv Grinstein, *The Growth of Executive Pay*, 21 OXFORD REV. OF ECON. POL'Y 282 (2005); Lucian A. Bebchuk & Robert J. Jackson, Jr., *Executive Pensions*, 30 J. CORP. L. 823 (2005); Lucian Arye Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751 (2002); Lucian Arye Bebchuk & Jesse M. Fried, *Executive Compensation as an Agency Problem*, 17 J. ECON. PERSP. 71 (2003); Lucian Arye Bebchuk & Yaniv Grinstein, *Firm Expansion and CEO Pay* (Nat'l Bureau of Econ. Research Working Paper No. W11886, Dec. 2005), available at <http://ssrn.com/abstract=875737>.

²⁰²Written Testimony, *supra* note 5, at 2.

²⁰³Joseph Giannone, *Shareholders Reject "Say on Pay,"* REUTERS, Apr. 10, 2007, available at <http://www.reuters.com/article/businessNews/idUSN1040609620070410?feedType=RSS>.

attempt to appease these norm entrepreneurs. The recent legislation passed by the House of Representatives was moved by House Financial Committee Chairman Barney Frank, a Democrat from Massachusetts, and is aimed at giving shareholders a right to cast an advisory vote on executive pay. The success of norms entrepreneurs is owed to a signaling effect—politicians want to signal to their constituents that they are working to advance their welfare, and by adopting the agendas of norms entrepreneurs, they do precisely that. It might also be dangerous for politicians with constituents who support the work of norms entrepreneurs to be seen as doing nothing.²⁰⁴ They might expose themselves to secondary shaming—as people who are too cowardly to enforce the social norm, and hence undeserving of reelection. Similarly, Abigail Barr explained that the results of her studies in rural Zimbabwe provide

strong evidence that the shame-based sanctions anticipated and imposed by the communities that took part in my experiments were effective at promoting cooperation. Villagers in Zimbabwe clearly care about what other people think of them and will modify their behaviour in order to improve their status in the eyes of their neighbours.²⁰⁵

Norms entrepreneurs create conditions for the birth of a secondary sanction for the enforcement of the underlying norm. When the risk of this sanction attaches to powerful groups like politicians who might otherwise free-ride, it advances the enforcement of the social norm enormously. This seems to be at the root of the activity against excessive CEO compensation.

IV. CONCLUSION

Social norms constrain CEOs and directors to act with regard for the interests of their shareholders. Social sanctions present a low cost method to enforce these norms. 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

²⁰⁴Barr, *supra* note 18, at 3, 13. "[S]anctions would be imposed upon non-cooperators by cooperators because by not cooperating the former are preventing the latter from getting their fair share. If the imposition of sanctions reduces the payoff to the sanctionee more than the payoff to the sanctioner, cooperators can redress this imbalance by sanctioning non-cooperators." *Id.* at 3. *See also* Ernest Fehr & Klaus M. Schmidt, *A Theory of Fairness, Competition and Cooperation*, 114 Q. J. OF ECON. 817 (1999) (discussing how fairness considerations motivate people because they want equitable outcomes and are willing to yield a payoff to create a fairer result).

²⁰⁵Barr, *supra* note 18, at 13.

comprehensible format. Shaming can decentralize the enforcement of the norm and facilitate investor protection without the need for regulatory expenditure. There is considerable evidence that greed is viewed unfavorably in financial situations and the deployment of emotions like disgust can achieve constraints on excessive CEO pay. This can be leveraged by agencies like the stock exchanges and institutional shareholders to influence the behavior of CEOs and corporate directors in positive ways.