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Cover Page Footnote

J.D., Northwestern Pritzker School of Law, 2021. The author would like to thank D.R.S. for his help in refining this note, and R.A.F., who would have done the same if he were able.

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Crowding Out Theory: Protecting Shareholders by Balancing Executives' Incentives in France, the United States, & China

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Abstract

This paper explores the differences between executive compensation regimes in France, the United States, and China. It asks whether there is a link between state regulation of real options as a form of executive compensation and state regulation of shareholder protections. This paper argues that if a country regulates the use of real options as compensation, then that country is also more likely to have strong shareholder protection laws. This argument seems to be true based on a descriptive review of executive compensation law and shareholder protections in France, the United States, and China.

If it is true that countries that regulate real options compensation are more likely to enact strong shareholders protections, then it is also likely that these countries are relying on the Crowding Out Theory. Under the Crowding Out Theory, executive compensation is designed to strike a balance between low pay, which motivates executives to work harder, and high pay, which disincentives executives from pursuing alternative forms of compensation that would harm shareholders.

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I. INTRODUCTION

Institutions, specifically legal institutions, exert significant control over executive compensation.[1] Because the law is a problem-solving tool, lawmakers reform executive compensation laws when they believe there is a problem with the way their country's executives are being compensated.[2] However, there is often a lack of consensus among lawmakers on what the problem with executive compensation actually is, or how executive compensation should be structured to solve the problem.[3] These disagreements are amplified across countries and cultures, resulting in differences in the laws addressing, and even defining, executive compensation.

This paper provides an overview of the differing legal rules for executive compensation in France, the United States, and China.[4] Prior papers studying the differences in executive compensation law across countries measured cultural values and highlighted social perceptions of compensation.[5] This paper instead proposes a link between state regulation of real option compensation and state regulation of shareholder protection.[6]

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[1] Laws, litigation procedures, business operating procedures, collective labor organizations, and taxes are all examples of institutions. *See generally* John R. Searle, *What is an Institution?*, 22 J. INSTITUTIONAL ECON. 1, 15-19 (2005).

[2] *See* Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer*, Law and Finance*, 106 J. POL. ECON. 1113, 1117-19 (1998) [hereinafter La Porta] (explaining that countries can be grouped into "legal families" depending on "(1) historical background and development of the legal system, (2) theories and hierarchies of sources of law, (3) the working methodology of jurists within the legal systems, (4) the characteristics of legal concepts employed by the system, (5) the legal institutions of the system, and (6) the divisions of law employed within a system") (citing MARY ANN GLENDON, MICHAEL W. GORDON & CHRISTOPHER OSKAWE, COMPARATIVE LEGAL TRADITION: TEXT, MATERIALS, AND CASES ON THE CIVIL AND COMMON LAW TRADITIONS, WITH SPECIAL REFERENCE TO FRENCH, GERMAN, ENGLISH, AND EUROPEAN LAW 4-5 (2d ed. 1994)).

[3] Payments might be gratuitous or improperly influencing executives' interests. *See* Johannes M. Pennings, *Executive Reward Systems: A Cross-National Comparison*, 30 J. MGMT. STUDIES 261, 261-62, 265-66 (1993) [hereinafter Pennings] (asking "[W]hat interpretive schemas do people in different organizations espouse about performance-reward relationships, and do they signal national differences? Do such schemas mirror values [power distance, uncertainty avoidance, individualism, and masculinity] that vary across nations?").

[4] This paper draws inspiration from cross-cultural studies but focuses primarily on legal institutions. The data needed to answer a question about the impact of culture on executive compensation does not exist at present, and in a controlled study with three countries there would be more control variables than observations.

[5] Amir N. Licht, Chanan Goldschmidt & Shalom H. Schwartz, *Culture, Law, and Corporate Governance*, 25 INT'L REV. L. AND ECON. 229, 235 (2005) (Table 1A defines the Schwartz cultural value dimensions (embeddedness/autonomy, hierarchy/egalitarianism, and mastery/harmony). Table 1B defines the Hofstede cultural value dimensions (individualism/collectivism, power distance, uncertainty avoidance, and masculinity/femininity)).

[6] Shareholders need not be private individuals. Rather, they may be government entities

The hypothesis is that when a government regulates the use of real options as compensation, that government is also more likely to have strong shareholder protection laws.[7] This hypothesis seems to be true based on a descriptive review of compensation law in France, the U.S., and China, but a quantitative study should be done with a larger group of countries to reach a definitive conclusion. This question is not about the pay-risk or pay-performance sensitivity of stock options compensation, although those issues are relevant. Rather, the goal is to identify whether governments that take measures to protect shareholders also limit real option compensation for executives.[8] If governments are relying on Crowding Out Theory it could explain a correlation between the strength of limits on real options as a form of executive compensation, an indirect form of shareholder protection, and the strength of more direct shareholder protection laws. A future qualitative study might consider controlling for the prevalence of state shareholders in different regimes, a factor explored in part below.

In Part III, this paper discusses the wide variety of forms that executive compensation can take and explores lawyers' and economists' theories on the functions that executive compensation may serve depending on its structure. This paper primarily relies on the Crowding Out Theory, under which executive compensation is designed to strike a balance between low pay, which motivates executives to work harder, and high pay, which disincentives executives from pursuing alternative forms of compensation that would harm shareholders. In Part IV, this paper discusses the actual practices and laws used to structure and limit executive compensation in France, the U.S., and China. In Part V, this paper explains common methods of shareholder protection. In Part VI, this paper provides an overview of how shareholders are protected in each of the three countries discussed. In Part VII, this paper concludes that, while the regulation of executive compensation and the prevalence of shareholder protection measures seem to be related, quantitative work needs to be done on the topic.

II. LIMITATIONS

Comparing specific laws is valuable because these three countries, China and France in particular, frequently look to other nations' laws when developing their own, such as when defining fiduciary duties. However, the mechanisms that work to address risky compensation under one system do not necessarily translate into another, and it is important to understand how

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such as State-Owned Enterprises (SOEs).

[7] Options can be stock options or real options. This paper focuses on real options, which are all the choices executives make in a business context, such as the flexibility to engage in self-dealing, to steal, to not work hard, or to abuse executive perks.

[8] Ramón Abascal & Francisco Gonzále, *Shareholder Protection and Bank Executive Compensation After The Global Financial Crisis*, 40 J. FIN. STABILITY 15, 34 (2019).

the adoption of a single law would actually impact a different economy or legal system.[9] The strength of executive compensation regulations is also not the only cross-country variable, as both state ownership and direct shareholder control over pay clearly play a role in the way real option compensation manifests. These factors should be given more consideration in a future paper. The significantly different legal regimes in each country and their distinct economic histories, ranging from heavy state involvement to relatively unregulated risk-taking, provide insight into why options might be a concern for China, where they have a demonstrated potential for abuse, but are far less of a concern for France. Further, the various legal enforcement mechanisms, agencies, and international organizations that create binding or soft laws either have different goals depending on the context or take unique paths to reach the same goal.

Because this paper only examines a limited part of a low-government control regime (U.S.), a mid-control regime (France), and a high-control regime (China), a future paper could ask a more specific question about the strength and clarity of specific compensation laws in each nation, potentially by observing how different countries' federal income tax laws define and treat gifts in the context of compensation.[10] Further, a future study could compare the length of time different countries' shareholders wait in court to litigate claims under equivalent laws (such as violations of fiduciary duties, which vary across countries), how much shareholders recover, and how often shareholders win.

If a future paper asks more specific questions about how laws affect companies in one or more of the countries discussed, there might be issues with data collection. French and American executives in private companies are not required to disclose pay, so this data is not available for comparison, and Chinese executives of listed State-Owned Enterprises' (SOEs) subsidiary companies do not disclose pay if they are paid by the unlisted parent rather than by the listed subsidiary.[11] Even if this data were available, there is a selection bias among companies that choose not to list, which could affect their decisions on executive compensation.[12]

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[9] Shen Wei & Casey G. Watters, *Do All Roads Lead to China?: Scholarship of Chinese Commercial Law in the Past Decade (Part 1)*, 16 CHINA REV. 165, 168 (2016) [hereinafter Wei] (It is naive to think China can simply adopt, by legal transplants, comprehensive commercial law statutes from other jurisdictions and achieve the same results.).

[10] *E.g.*, 26 U.S.C.A. § 102 (2010); T.D. 1-655, 97 C.B. 1 (1919)(discussing Revenue Act of 1918 § 213); *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716, 718 (1929) ("Employer's payment of income taxes assessed against employee *held* to constitute 'additional taxable income' to employee, as consideration for services rendered.").

[11] Li-Wen Lin, *Revisiting Executive Pay of China's State-Owned Enterprises: Formal Design, Fresh Data, and Further Doubts*, 19 U.C. DAVIS BUS. L.J. 27, 29 (2018) [hereinafter Li-Wen Lin].

[12] There are many factors other than reporting requirements that influence companies not to list their shares on stock exchanges.

III. HOW CAN EXECUTIVES BE COMPENSATED?

While money is the first thing that comes to mind when discussing compensation, payment is not always straightforward, and in fact can be nearly impossible to quantify or to identify at all.[13] Executive compensation can, and should, include obvious elements, such as a salary, bonus, stock options, stock appreciation rights, a performance share plan, deferred compensation, healthcare, or a pension. However, compensation can also include less obvious and more questionable elements such as a golden parachute, the opportunity to engage in self-dealing, and other privileges that vary widely based on external factors such as shareholder protections, social norms, and the individual being compensated.[14]

After lawmakers have identified the form executive compensation tends to take in their country, they must then consider various theories of compensation to improve compensation's function. These theories address a range of issues from solving the agency problem, to keeping executives in check, to maximizing executive performance, to attracting talent, to identifying non-pecuniary incentives. It is not until form and function are considered together that lawmakers can address perceived problems with their country's compensation laws.

a. *Forms of Compensation*

All executive compensation fits into one of two categories: it is either non-pecuniary compensation or pecuniary compensation.[15] Non-pecuniary

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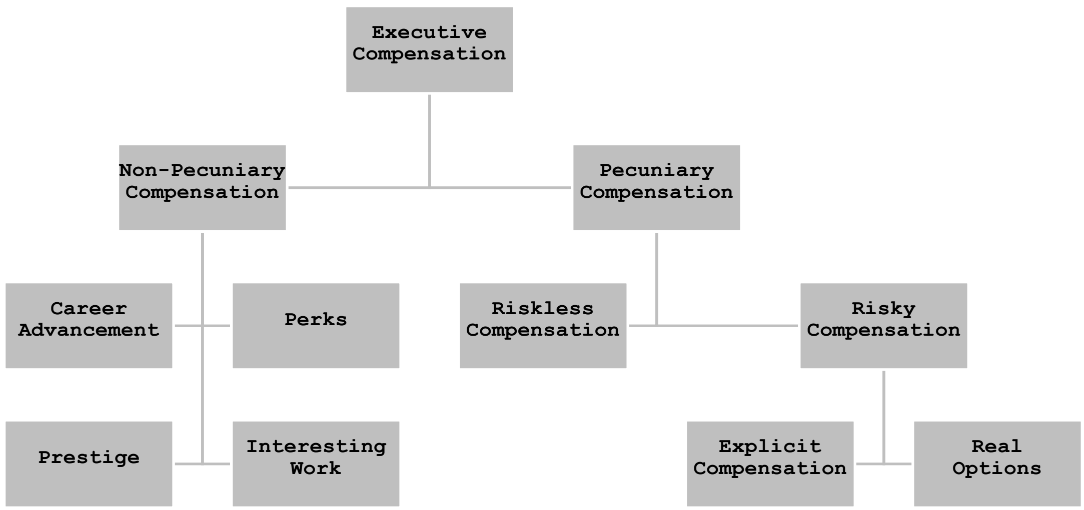
[13] If compensation were strictly pecuniary, an attorney with a market value of $190,000 USD annually would never accept a federal clerkship for $50,000 USD annually. However, this choice is not uncommon because of non-pecuniary compensation. In this situation, the hypothetical attorney values adding "federal clerkship" to their resume at $140,000 USD, whether that value is coming from increased reputation, status, value in the labor market, or from personal enjoyment of the experience.

[14] *See* TAPOMOY DEB, MANAGING HUMAN RESOURCES AND INDUSTRIAL RELATIONS 396 (1st ed. 2009). *See generally* ELIZABETH A. ISING ET AL., EXECUTIVE COMPENSATION DISCLOSURE HANDBOOK: A PRACTICAL GUIDE TO THE SEC'S EXECUTIVE COMPENSATION DISCLOSURE RULES (2016), https://www.gibsondunn.com/wp-content/uploads/documents/publications/Ising-Mueller-Hanvey-Executive-Compensation-Disclosure-Handbook-Donnelley-Financial-Solutions-Oct-2016.pdf (discussing salaries, bonuses, stock awards, option awards, non-equity incentive plans, pensions, nonqualified deferred compensation, plan-based awards, outstanding equity awards, payments upon termination or change in control, and golden parachutes); Kevin J. Murphy, *Executive Compensation: Where We Are, and How We Got There*, HANDBOOK OF ECON. FIN. (2012) (describing various forms of executive compensation present during, or prior to, 2012). *See also* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976) (pioneering a theory of ownership structure for the firm based on the theories of: (1) agency; (2) property rights; and (3) finance).

[15] *See, e.g.,* Yannis Georgellis et al., *Pecuniary and Non-Pecuniary Aspects of Self-Employment Survival*, 47 Q. REV. ECON. AND FIN. 94, 106 (2007) (providing an example of how pecuniary and non-pecuniary compensation work in conjunction). *See also* Michael C. Jensen & Kevin J. Murphy, *CEO Incentives-It's Not How Much You Pay, But How*, 3 J.

compensation means non-monetary benefits and is an extremely broad category, encompassing economic and social factors such as job satisfaction, future career opportunities, and prestige. Pecuniary compensation includes the most obvious traditional forms of payment, including salary, stock options, and bonuses. Pecuniary compensation can be either riskless or risky, and risky compensation exists as either explicit compensation or as real options.



Riskless compensation includes salaries and pension plans, which are relatively certain.[16] Risky compensation can be either explicit compensation or real options, both of which are relatively uncertain.

Explicit compensation includes stock and stock options, whereas real options include all strategic business choices, not just financial options.[17] Real options therefore include all choices executives make in a business context.[18] Ideally, the executive will choose to maximize business opportunities and minimize its obligations, but the executive can choose illicit real options instead, such as the flexibility to engage in self-dealing, to steal, to not work hard, or to abuse executive perks. Financial options are a subset of real options, where the executive has a specific right to buy or

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Applied Corp. Fin. 36, 45-46 (1990) (discussing problems with pecuniary and non-pecuniary incentives).

16 *See* Deb, *supra* note 14, at 394.

17 *See* Keith J. Leslie & Max P. Michaels, *The Real Power of Real Options*, 3 THE MCKINSEY QUARTERLY 5, 6, 10 (1997) ("[A]ll business decisions are real options, in that they confer the *right* but not the *obligation* to take some initiative in the future." Overlooking real options and considering only explicit compensation would "ignore the value of flexibility.").

18 *Id*. at 17.

sell one of the company's financial assets.[19]

b. Functions of Compensation

The primary goal of compensation is to pay an individual for their services because those services cannot be obtained without compensation. However, while obtaining services is the most important objective, the secondary goals of compensation—aligning directors' interests with shareholders' interests, attracting talent, and discouraging theft—are still extremely relevant.[20] The following theories explore the range of goals a compensation committee might have when setting executive compensation and the compromises the committees might make in pursuit of those goals. These theories will be broken down to reflect five major goals: (1) solving the agency problem; (2) keeping executives in check; (3) maximizing executive performance; (4) attracting talent; and (5) identifying non-pecuniary incentives.

Agency Theory, Optimal Contracting Theory, Crowding Out Theory, and Risk Adjustment Theory seek to solve the agency problem. Under Agency Theory, some incentives align the executive's interests with shareholders' interests while others push these parties' interests further apart.[21] Optimal Contracting Theory optimistically suggests that executive compensation is a governance mechanism that resolves agency conflicts with shareholders.[22] Under Crowding Out Theory, determining executive compensation means balancing low-pay, which motivates executives to work harder, with high-pay, which disincentivizes executives from pursuing alternative forms of compensation that might harm shareholders.[23] Under Risk Adjustment Theory, executives who hold riskier forms of compensation must be compensated with salaries and bonuses that offset the risks and incentivize them to take an appropriate amount of risk for the company.[24]

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[19] *Id*. at 12 ("[W]hereas a financial option is acquired and exercised in a deep and transparent market, real business situations usually feature a limited number of players interacting with one another, each of which can influence the . . . option value.").

[20] *See* Marco Heimann et al., *Peoples' Views About the Acceptability of Executive Bonuses and Compensation Policies*, 127 J. BUS. ETHICS 661, 663–64 (2015)(In the context of executive compensation, the dimensions of social justice are: (1) retributive; (2) procedural; (3) distributive; and (4) restorative justice). The corresponding renumeration strategies are: (1) high renumeration; (2) transparency and fairness in resource allocation; (3) the attribution of renumeration; and (4) special bonuses for adversely affected employees.).

[21] Pennings, *supra* note 3, at 263-64.

[22] Lin Lin, *Regulating Executive Compensation in China: Problems and Solutions*, 32 J. L. & COM. 207, 210-211 (2014) [hereinafter Lin Lin]; Rim Ben Hassen et al., *Executive Compensation and Ownership Structure*, 31 J. APPLIED BUS. RES. 593, 594 (2015).

[23] Deb, *supra* note 14, at 381. (explaining that executives might take advantage of real options if they do not receive enough pecuniary compensation).

[24] Randall S. Thomas, *Explaining the International CEO Pay Gap: Board Capture or Market Driven?*, 57 VAND. L. REV. 1171, 1179 (2004) [hereinafter Thomas].

Bargaining Power Theory and Board Capture Theory focus on keeping executives in check by preventing executives from setting their own compensation to the detriment of the company. Under Bargaining Power Theory, executives have substantial power in hostile takeovers and can bargain for greater compensation, such as accepting a large personal payment to relinquish their seat on the board and facilitating friendly deals while benefitting themselves.[25] Under Board Capture Theory, the executives on the boards of public companies who nominate directors are rewarded with significant compensation for those nominations and are therefore incentivized to keep compensation high.[26]

Expectancy Theory, Teamwork Theory, and Tournament Theory seek to maximize executive performance. Under Expectancy Theory, effort is tied to performance and performance is tied to rewards, which may inspire executives to expend greater effort.[27] Under Teamwork Theory, unequal pay fosters rivalry, so executives are less competitive when their compensation is relatively equal.[28] Finally, under Tournament Theory, winning the highest executive compensation package is seen as a way to demonstrate that an executive has outcompeted their peers.[29]

Human Capital Theory, Marginal Revenue Product Theory, Efficiency Wage Theory, Opportunity Cost Theory, and Superstar Theory ask how companies can attract and keep talented executives. Under Human Capital Theory, the higher an executive's human capital (skills, connections, and experience) the higher that executive's compensation.[30] Under Marginal Revenue Product Theory, determining executive compensation means weighing the availability of jobs against the availability of executives capable of performing the work.[31] Similarly, under Efficiency Wage Theory, when an executive's compensation is higher, the executive is less likely to leave the company and more likely to work for the company.[32] Under Opportunity Cost Theory, when an executive's compensation is

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[25] *Id.* at 1178; *See generally* STERN SCHOOL OF BUSINESS, N.Y.U., EXECUTIVE COMPENSATION AND SHAREHOLDER VALUE: THEORY AND EVIDENCE (Jennifer Carpenter & David Yermack eds., 1999) (discussing the conflicted, "interlocking" nature of compensation decisions, resulting from the board's involvement in the process).

[26] Thomas, *supra* note 24, at 1176 (arguing that "Marginal Revenue Product Theory, Tournament Theory, Opportunity Cost Theory, Bargaining Theory, and Risk Adjustment Theory-[offer] better explanations for the international CEO pay gap than Board Capture Theory").

[27] Pennings, *supra* note 3, at 263 (Expectancy Theory posits individual differences, while Agency Theory treats individuals in a standardized fashion.).

[28] Lin, *supra* note 11, at 49.

[29] Deb, *supra* note 14, at 379-81 (discussing Marginal Revenue Product Theory, Human Capital Theory, Efficiency Wage Theory, Opportunity Cost Theory, Superstar Theory, Tournament Theory, Figurehead Theory, Stewardship Theory, and Crowding Out Theory).

[30] *Id.* at 380.

[31] *Id.*

[32] *Id.*

higher than other executives' compensation, the less likely that executive is to leave the company in search of higher compensation.[33] Finally, under Superstar Theory, talented executives are compensated disproportionately as compared to less talented executives because the talented executives cannot be replaced.[34]

Figurehead Theory and Stewardship Theory highlight the non-pecuniary incentives which executives might find attractive. Under Figurehead Theory, status gained by becoming a figurehead is a form of non-pecuniary executive compensation.[35] And under Stewardship Theory, executives are similarly compensated by shareholder satisfaction, in part because they are shareholders' "stewards" who are acting in shareholders' best interests.[36]

While this is by no means a comprehensive overview of executive compensation theory, thinking about the different theories a compensation committee or lawmaker might use to structure executive compensation provides a framework to think about the benefits and risks compensation can present to directors and shareholders. This paper will primarily work within Crowding Out Theory, focusing on the idea of regulating real options compensation to disincentivize executives from pursuing the types of alternative compensation that harm shareholders. If governments are relying on Crowding Out Theory, this could explain a correlation between the strength of limits on real options as a form of executive compensation, an indirect form of shareholder protection, and the strength of more direct shareholder protection laws.

IV. THE CURRENT STATE OF EXECUTIVE COMPENSATION REGULATION, INSTITUTIONS, & ACTUAL PRACTICES IN FRANCE, THE UNITED STATES, & CHINA

Asking how real options are regulated as a form of executive compensation in a low-government control regime (U.S.), mid-control regime (France), and high-control regime (China) is important because the issue of fairness in executive compensation has become increasingly contentious since shareholders suffered through the 2008 global financial crisis.[37] With recent changes in the law, France now has strong executive compensation laws, the United States has moderate executive compensation laws, and China has comparatively weak executive compensation laws.

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[33] *See Id.*

[34] *Id.*

[35] *Id.* at 381.

[36] *Id.*

[37] Ramón Abascal & Francisco González, *Shareholder Protection and Bank Executive Compensation after the Global Financial Crisis*, 40 J. FIN. STABILITY 15 (2019) (explaining the financial crisis as an "exogenous shock potentially affecting banks' investment opportunities" and focusing on the change in pay-risk sensitivity and risk-taking incentives embedded in executive compensation before and after the crisis).

For example, France is subject to E.U. laws which regulate executive compensation aggressively. One such law is Sapin II, a "Say on Pay" law that gives shareholders a binding vote on whether or not executives' salaries should be reduced.[38] In the comparatively moderate United States, the federal government has increased its focus on "reasonable" compensation, of which options are a significant part, but there is a circuit split and no clear federal limit. Finally, China faces significant challenges when regulating real options because executives exercising those options are frequently agents of the state, and the state is overwhelmingly a shareholder in public Chinese companies.

Given the lack of data on compensation and the impossibility of evaluating the prevalence or value of non-pecuniary compensation, the goal is not to evaluate the true financial impact of laws addressing executive compensation.[39] The following review of legislative history is instead meant to provide background on some of the key executive compensation issues that France, the United States, and China have addressed over the last century, and to explore the ways that lawmakers in each country perceive compensation's form and function. Further, this overview examines the degree to which option compensation seems to be a concern for each country's lawmakers, and evaluates whether the laws in place are achieving the desired effect of restricting executives' use of option compensation where lawmakers have decided that it is a problem.

a. France

Beginning in the 18th century, the French State was a major owner and controlling shareholder in a variety of large companies.[40] Because French law grants controlling shareholders significant rights, the government was able to exercise considerable influence over the economy.[41] After France opened nationalized companies to private investors in the post-war period and created a mixed economy, corporate executives had more flexibility to pursue diverse business goals, although the state still had to approve directors' business plans.[42] While private ownership has significantly

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38 Irene Bucelli, *Glass, Lewis & Co., France's First Binding "Non" on Say-On-Pay*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Aug. 7, 2019), https://corpgov.law.harvard.edu/2019/08/07/frances-first-binding-non-on-say-on-pay/ [hereinafter Bucelli].

39 Private American and French companies do not have to report compensation and there is inaccurate SASAC data in China. *See* China Daily, *State-owned Assets Supervision and Administration Commission of the State Council* (2020), http://en.sasac.gov.cn. (The State Council operates the State-owned Assets Supervision and Administration Commission ("SASAC") to track economic performance of Chinese companies.).

40 James A. Fanto, *The Role of Corporate Law in French Corporate Governance*, 31 CORNELL INT'L L.J. 31, 40 (1998) [hereinafter Fanto]; La Porta, *supra* note 2, at 1118 (French law is civil law.).

41 Fanto, *supra* note 40*,* at 40.

42 *Id.* at 41 ("The State often operated a profit-making business for purposes unrelated to

increased over the past half-century, state control is not entirely absent from French corporate governance, and the concept of state control over executives is prevalent.[43]

In 1994, the Committee for Banking Regulation recommended that French companies publicly disclose information about executive compensation.[44] By 2001, France heightened restrictions on self-dealing transactions and on executive compensation in the form of options. Against this background, and in the face of mounting press coverage on executive pay, France responded to the 2008 financial crisis by reforming executive compensation.[45] In the immediate period following the crisis, France addressed "golden parachutes."[46] More recently, the French Anticorruption Agency enacted Sapin II, which outlined how to manage risk and established binding "Say-on-Pay" voting.[47] These changes occurred against a backdrop of extensive, if somewhat disordered, mandatory disclosures of company information to shareholders and variable voting rights.[48]

In the early 2000s, France built on existing regulations to prohibit self-dealing contracts, a form of real options, by board members in high-risk transactions.[49] While French law addressed self-dealing transactions as early as the late nineteenth century, it was not until the early 2000s that France set procedures to govern transactions where an officer, director, or 10% shareholder had an interest, however indirect, in a transaction.[50] Now, a majority of a French board's disinterested members must approve the transaction, the chairman of the board must obtain a statutory auditor's report, and a majority of disinterested shareholders must also approve the

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the specific financial well-being of the firm, such as to address unemployment, distribution of credit, and public services.").

[43] *Id.* at 43-44.

[44] Alain Alcouffe & Christiane Alcouffe, *Executive Compensation-setting Practices in France*, 33 LONG RANGE PLAN. 527, 531 (2000).

[45] PEPPER D. CULPEPPER, QUIET POLITICS AND BUSINESS POWER: CORPORATE CONTROL IN EUROPE AND JAPAN, 173 (2011) (In April 2009, 1.5% of French articles covered executive compensation.).

[46] Geneviève Helleringer, *Related Party Transactions in France - A Critical Assessment*, 4 n.13 (Eur. Corp. Governance Inst., Working Paper No. 474, 2019) [hereinafter Helleringer].

[47] Bucelli, *supra* note 38; Philippe Bouchez El Ghozi & Morgan A. Heavener, *French Anticorruption Agency Issues Detailed New Guidelines for Compliance with Sapin II* (Apr. 16, 2018), https://www.paulhastings.com/publications-items/details/?id=4c43866a-2334-6428-811c-ff00004cbded [hereinafter Bouchez].

[48] Fanto, *supra* note 40, at 48–51 (A company may grant a shareholder double voting rights if he or she holds shares in registered (as opposed to bearer) form for at least two years.).

[49] Helleringer, *supra* note 46, at 7. *Cf.* Pennings, *supra* note 3, at 268 (explaining that French executives "are not for sale" and do not require contracts, although French law explicitly prohibits executives from forming self-dealing contracts in many cases).

[50] Helleringer, *supra* note 46, at 7 n.32.

transaction.[51] Further, no company is permitted to make loans on behalf of an inside director unless that director is a legal person, eliminating the opportunity for self-dealing through loans.[52] One issue with this law is that "indirect interest" is left somewhat undefined in the French statute, although board chairs, directors, and CEOs of both listed and unlisted companies can be criminally liable for abusing a corporation's assets.[53]

Starting around 2007, France increased government scrutiny of "golden parachutes," a type of pecuniary compensation, by prohibiting companies from paying resigning corporate officers any deferred compensation that was not conditional on their achievement of performance objectives.[54] The French Business Confederation's 2008 Code of Corporate Governance (unenforceable soft law) went even further, prohibiting "golden parachutes" altogether.[55] These real and aspirational changes were a step towards tying performance to compensation, but they did not legally force companies to tie performance to compensation across the board. Although some French executives have taken the radical step of voluntarily forgoing receiving bonuses, French law does not completely prohibit executives from receiving bonuses unrelated to performance.[56] On balance, however, executive compensation laws in France are extremely progressive.

Further, as an E.U. member state, France is subject to E.U. regulations, many of which have been catalysts for change in French law. One of the E.U.'s first initiatives against excessive executive compensation came on July 6, 2010, when the European Parliament adopted the Capital Requirements and Bonuses Package ("CRBP"). As part of the Capital Requirements Directive ("CRD"), the CRBP initiative affected European banks by capping cash bonuses at 30% of the total bonus (and at 20% for "large bonuses" as defined by France), requiring that 50% or more of each bonus be comprised of contingent capital or shares, and mandating that 40% or more of each bonus be deferred (60% for "large bonuses" as defined by France) for at least three to five years, then reduced based on how the executive's transactions turn out.[57] While this law applies only to

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[51] *Id.* at 8-9; CODE DE COMMERCE [C. COM.] [COMMERCIAL CODE] art. L. 225-38, art. L. 225-40, para. 2, art. L. 225-40, para. 2-4.

[52] Helleringer, *supra* note 46, at 10; COMMERCIAL CODE art. L. 225-43.

[53] Helleringer, *supra* note 46, at 8, 12 (summarizing COMMERCIAL CODE art. L. 242-6).

[54] *See* Georges A. Cavalier, *On French Interventions in the Financial Crisis*, 35 BROOK. J. INT'L L. 785, 792 (2010) (noting that the 2007 TEPA Law in Favor of Labor, Employment and Purchasing Power "ensure[s] that 'golden parachutes' are not a 'reward for failure'") [hereinafter Cavalier]. *See generally* Hervé Touraine & Olivier Bernard, *Structured finance and securitisation in France: overview*, THOMSON REUTERS PRAC. L. (2016), https://uk.practicallaw.thomsonreuters.com/4-501-0172?transitionType=Default&contextData=(sc.Default)&firstPage=true].

[55] Cavalier, *supra* note 54, at 792-93.

[56] *Id*.

[57] Oxford Analytica, *E.U. Adopts New Executive Pay Standards*, (Jul. 12, 2010, 6:00 AM) https://www.forbes.com/2010/07/09/eu-executive-pay-business-oxford-analytica.html.

E.U. banks, E.U. operations of foreign banks and institutions, and third-country subsidiaries of E.U. banks, it represents a strong critique of executive pay unrelated to performance across all industries in the E.U.[58]

In 2013, the CRD introduced "Say on Pay" voting through soft law, which France formally adopted through national legislation.[59] Later, the May 2017 Shareholder Rights Directive ("SRD") recommended that shareholders review executive compensation on a long-term basis, a measure which France has also adopted.[60] The European Council began planning the law in 2013, inspired by Switzerland's then-new initiative to empower shareholders.[61] While E.U. member states interpret the directive according to their national systems of law, a core part of SRD is providing shareholders with information about executive compensation so shareholders can more effectively regulate executive pay.[62]

In 2018, France set out a six-step method under Sapin II to prevent risks related to corruption, which fall under the options category of executive compensation.[63] Companies with over 500 employees and annual revenues in excess of 100 million euros must identify how risk will be mapped, identify corruption risks "inherent" in the company's activities, evaluate the company's exposure to the identified risks, assess whether current risk management methods are sufficient, address outstanding risks, and regularly update the risk map.[64] Unlike the French Business Confederation's unenforceable soft-law measures against "golden parachutes," the Sapin II guidelines hold more legal weight.[65] While the guidelines published by the AFA (the regulatory body created by Sapin II) are non-binding, they are strong indicators of what the French Public Prosecutor will prosecute, and the AFA can sanction qualifying companies that violate the guidelines.[66] Also in 2018, France established "Say on Pay"

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[58] *Id.*

[59] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on Access to the Activity of Credit Institutions and the Prudential Supervision of Credit Institutions and Investment Firms, 2013 O.J. (L 176) 338.

[60] *See* Directive (EU) 2017/828 of the European Parliament and of the Council of 17 May 2017 Amending Directive 2007/36/EC as Regards the Encouragement of Long-Term Shareholder Engagement, 2017 O.J. (L 132) 1.

[61] John O'Donnell & Sinead Cruise, *Europe Moves Towards Swiss-Style Executive Pay Curbs*, (Mar. 6, 2013, 8:05 AM), https://www.reuters.com/article/us-eu-pay/europe-moves-towards-swiss-style-executive-pay-curbs-idUSBRE9250WM20130306.

[62] BROADRIDGE, SHAREHOLDER RIGHTS DIRECTIVE: ADVANCING TO A STATE OF READINESS 4 (2017); Directive 2017/828/EU of the European Parliament and of the Council of 17 May 2017 Amending Directive 2007/36/EC as Regards The Encouragement of Long-Term Shareholder Engagement, 2017 O.J. (L 132) 2.

[63] Bouchez, *supra* note 47.

[64] *Id.*

[65] Law No. 2016-1691 on Transparency, Fighting Corruption and Modernizing Economic Life. This law is binding.

[66] George A. Stamboulidis, Susrut A. Carpenter & Sophie Rouach, *Two Years Since*

voting under Sapin II.[67] This drastic measure against executive compensation reflects the goals of the E.U. 2017 SRD.[68] While a soft-law version of "Say on Pay" has been a part of French law since 2013, listed companies now face binding ex-ante and ex-post votes on executive compensation.[69]

b. United States

The United States regulates executive compensation through both state and federal laws.[70] In the 1970s, a shift in executive pay towards perks and options inspired the SEC to expand disclosure requirements surrounding executive compensation.[71] This development contributed to the issue of "unreasonable" compensation, although different federal circuits have dealt with the problem in different ways.[72]

More recently, the U.S. federal government has heightened disclosure regulations after excessive use of options contributed to the 2008 financial

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Sapin II: Is France Now a Player in the Global Anti-Corruption Enforcement Arena?, BAKERHOSTETLER (June 24, 2019), https://www.bakerlaw.com/alerts/two-years-since-sapin-ii-is-france-now-a-player-in-the-global-anti-corruption-enforcement-arena (The AFA cannot investigate or prosecute criminal offenses and cannot settle with target companies through the CJIP process. It can only refer Sapin II violations to the French Public Prosecutor, the Parquet National Financier.).

[67] *Id.*; Alain Pietrancosta, *Say on Pay: The New French Legal Regime in Light of the Shareholders' Rights Directive II*, 3 REVUE TRIMESTRIELLE DE DROIT FINANCIER [R.T.D.F.] 105, 107 (2017) [hereinafter Pietrancosta].

[68] Pietrancosta, *supra* note 67, at 106-08 (explaining that remuneration policy must "contribute to the company's business strategy and long-term interests and sustainability and shall explain how it does so" and "explain how the pay and employment conditions of employees of the company were taken into account when establishing the remuneration policy" (Art. 9(a)(6))).

[69] *Id.* at 107; Bucelli, *supra* note 38 (explaining that an ex-post vote addresses remuneration for the former CEO for fiscal year 2018, while an ex-ante vote addresses proposed remuneration for the current CEO for fiscal year 2019).

[70] *See generally* Sarah H. Burghart, *Overcompensating Much? The Impact of Preemption on Emerging Federal and State Efforts to Limit Executive Compensation*, 2009 COLUM. BUS. L. REV. 669 (2009) (analyzing a selection of state and federal laws that control executive compensation).

[71] KEVIN J. MURPHY, THE POLITICS OF PAY: A LEGISLATIVE HISTORY OF EXECUTIVE COMPENSATION 4-5 (2011). Item 402 of the Securities Act regulating executive compensation was implemented in 2006. 17 C.F.R. § 229.402 (2020), LEGAL INFORMATION INSTITUTE, https://www.law.cornell.edu/cfr/text/17/229.402. *See generally* Robert E. Scully Jr., *Executive Compensation, the Business Judgment Rule, and the Dodd-Frank Act: Back to the Future for Private Litigation?*, 36 FED. LAW. (2011), https://www.sec.gov/comments/df-title-ix/executive-compensation/executivecompensation-58.pdf.

[72] Sean Morrison & Andy Howlett, *A Big Return to Reasonable Compensation*, 163 Tax Notes Fed. 1957, 1960-61 (2019) [hereinafter Morrison] (explaining the modern American reasonableness standard); U.S. CONST. art. I, § 8, cl. 1. ("The Congress shall have Power to lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defense and general Welfare of the United States; but all Duties, Imposts and Excises shall be uniform throughout the United States.").

crisis. Similarly, state courts—and Delaware's courts in particular—have a robust body of law used to protect shareholders when executives breach their fiduciary duties by engaging in conflicted transactions.[73] At present, federal securities law applies to reporting companies and mandates disclosure, federal tax law applies to all companies and deals with questions of reasonableness, and Delaware General Common Law applies to companies incorporated in Delaware and enforces both the fiduciary duties of care and loyalty.

Since the late 1940s, U.S. federal courts have been asked how much compensation is reasonable, with different circuits coming to extremely different conclusions about which factors should be used or whether factors should be used at all.[74] Among courts that use factor tests, there is a general consensus that an employee's role within a company, the compensation received by similarly-situated employees, the "character and condition" of the company, conflicts of interest, and the consistency of compensation within the company are all relevant.[75] Among courts that use independent investor tests, the question is "after compensation is paid to shareholder-employees, [does] the remaining profit in the business provide[] a rate of return on equity that would satisfy an independent investor[?]".[76]

At the state level, the Delaware General Corporation Law ("DGCL") outlines directors' fiduciary duties of care and loyalty and provides that executive compensation cannot be a "waste of assets."[77] Under the duty of loyalty, executives have a responsibility not to engage in conflicted or "self-dealing" transactions, such as setting their own pay, because they cannot complete this task while remaining fully loyal to their shareholders.[78] To

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[73] *See* Leo E. Strine, Jr., *The Dangers of Denial: The Need for a Clear-Eyed Understanding of the Power and Accountability Structure Established by the Delaware General Corporation Law*, 50 WAKE FOREST L. REV. 761, 768-81 (2015); DELAWARE DIVISION OF CORPORATIONS, *Annual Report Statistics* (2018). https://corp.delaware.gov/stats/ (Fortune 500 corporations overwhelmingly chose Delaware as their state of incorporation in 2018.).

[74] Morrison, *supra* note 72, at 1960-61.

[75] *Id*. at 1962-66.

[76] *Id*. at 1966. *See* IRC § 199A Qualified Business Income.

[77] *See* Robert A. Kutcher, *Breach of Fiduciary Duties*, *in* BUS. TORTS LITIG., 3, 3 (2d ed. 2005) ("(1) Did a fiduciary relationship exist at the time of the alleged misconduct? (2) If so, what was the scope of the relationship? (3) Was there a breach of the duties that arose within the scope of the relationship?"). *See generally* 7B AM. JUR. PL. & PR. FORMS CORPS. § 143 *Complaint, petition or declaration—Allegation—Breach of fiduciary duty—Waste of corporate assets* (2019) ("The fiduciary duty imposed on the directors of a corporation includes a duty not to waste corporate assets. When a transaction is not approved by a disinterested board of directors, and there is no shareholder ratification of the transaction, the court must employ its own judgment in determining whether the evidence shows that the directors used the utmost good faith and the most scrupulous fairness in approving the transaction.").

[78] *E.g. Espinoza v. Zuckerberg*, 124 A.3d 47, 54 (Del. Ch. 2015) ("Where directors make decisions about their own compensation, those decisions presumptively will be

avoid a conflicted transaction, which would trigger use of the entire fairness standard of review should shareholders litigate, Delaware companies often use compensation consultants.[79] Counterintuitively, the introduction of compensation consultants has actually raised compensation by incentivizing consultants to set high compensation packages so companies will continue to use their services.[80]

There are no legal caps on executive compensation in any of these federal or state laws, and shareholder votes on executive compensation are only advisory.[81] Further, regardless of the legislative measures implemented to address excessive risk and unreasonable compensation, American shareholders are at a disadvantage when litigating violations of federal or state law. Due to the way American corporate lawsuits are structured, shareholders' money will be used to fund the board's defense attorneys and may even be used to pay settlements if insurance, indemnity, and personal liability are not applicable.

c. China

Between 1949 and 1978, China had a centrally planned economy and a socialist public ownership system.[82] Under this arrangement, managers received a government-determined salary free from equity incentives.[83] Over the past half-century, however, the Chinese Communist Party

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reviewed as self-dealing transactions under the entire fairness standard rather than under the business judgment rule."); *Lewis v. Vogelstein*, 699 A.2d 327, 336 (Del. Ch. 1997) ("[I]nformed, uncoerced, disinterested shareholder ratification of a transaction in which corporate directors have a material conflict of interest . . . [protects] the transaction from judicial review except on the basis of waste."); *Michelson v. Duncan*, 407 A.2d 211, 217 (Del. 1979) ("The essence of a claim of waste of corporate assets is the diversion of corporate assets for improper or unnecessary purposes.").

[79] Martin J. Conyon, *Executive Compensation Consultants and CEO Pay (Chief Executive Officer)*, 64 VAND. L. REV. 397 (2011) (discussing the role of executive compensation consultants in setting CEO pay).

[80] *Id*. at 406-07 (As of 2011, the five leading consultants advise 70% of all firms in the S&P 1500, and over 75% of the constituents of the S&P 500.).

[81] *E.g.*, 17 C.F.R. § 240.14a-21. *See generally* Steven N. Kaplan, *Executive Compensation and Corporate Governance in the U.S.: Perceptions, Facts and Challenges*, CHI. BOOTH PAPER NO. 12-42 (2012) (explaining and challenging the American belief that: (1) CEOs are overpaid and their pay keeps increasing; (2) CEOs are not paid for their performance; and (3) boards do not penalize CEOs for poor performance); Joseph E. Bachelder III, *Say-on-Pay Under Dodd-Frank*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Sept. 17, 2011) https://corpgov.law.harvard.edu/2011/09/17/say-on-pay-under-dodd-frank/ (Dodd-Frank Section 951 is not intended to change the fiduciary rules applicable to officers and directors of public corporations, but a negative say-on-pay vote may be taken into account as evidence of failure of officers and directors to meet their fiduciary responsibilities.).

[82] Lin Lin, *supra* note 22, at 213.

[83] *Id.* at 214; Qiang Cheng, Terry D. Warfield, *Equity Incentives and Earnings Management*, 80 ACCT. REV. 441 (2005) (Equity incentives arise from stock-based compensation and stock ownership.).

("CCP") has gradually privatized both State-Owned Enterprises ("SOEs") and businesses, decentralized the government, introduced equity incentives as a form of executive compensation, and separated property ownership rights from property control rights. These legal changes led to the prevalence of options as a form of executive compensation in SOEs, heightening executives' incentives to engage in collusion–activity that benefits agents and supervisors at shareholders' expense.[84] China's government has responded to this trend by regulating both the transfer of property rights and the presence of equity incentives in SOEs and private businesses and by articulating fiduciary duties, but China has yet to draft legislation limiting options as a form of executive compensation.[85]

After the "property rights reform" movement led to privatization and granted SOEs greater property control rights, China's government decentralized, giving local officials the ability to promote their subordinates. This change provided officials non-pecuniary compensation in the form of bargaining power over their subordinates' careers.[86] During this period, the government-determined salary that had prevailed for the prior three decades was loosened to allow for variation in executive bonuses, further exacerbating the issue of bargaining power, as executive positions became increasingly lucrative.[87]

In 1984, the CCP introduced equity incentives to the Chinese economy for the first time when the SOE Beijing Tianqiao Department Store Company became a private company limited by shares.[88] While the use of equity incentives is somewhat restricted (Chinese firms can repurchase only a limited number of shares issued in public offerings to give to their employees as equity incentives), the use of equity incentives was still a

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[84] MINXIN PEI, CHINA'S CRONY CAPITALISM 25, 29 (2016) (explaining the social structures that facilitate collusion, or "crony capitalism," in China) [hereinafter Pei].

[85] Lin Lin, *supra* note 22, at 207-08 ("[T]he primary role of Chinese law in regulating executive compensation should . . . be to improve the regulatory structure for setting executive pay in a fairer and more transparent way."); *see also Legal Research Guide: China*, LIBRARY OF CONGRESS, https://www.loc.gov/law/help/legal-research-guide/china.php (last updated Dec. 8, 2016)(China has a civil legal system).

[86] Pei, *supra* note 84, at 35; Li-Wen Lin, *supra* note 11, at 53, 59 ("The personnel linkages across the government and the SOEs also suggest that the hybrid identity of SOE managers – as business managers and government officials (perhaps more of the latter) – has significant impact on incentives. The main incentive of Chinese government officials is political career advancement rather than formal financial remuneration. Political promotions permit greater power to develop corrupt patronage networks, through which SOE executives may engage in systematic looting to amass tremendous personal wealth.").

[87] Lin Lin, *supra* note 22, at 214-15 (By 1988, state-appointed managers could earn up to 300% more than their average employee, while state-appointed operators could earn up to 500% more.); Li-Wen Lin, *supra* note 11, at 59 (China has moved towards a dual-pay system, wherein SOE executives coming from the state system are paid less than SOE executives coming from outside the state system, who receive a market rate. However, important state positions are closed to these non-state employees.).

[88] Lin Lin, *supra* note 22, at 215.

notable endorsement of riskier forms of pecuniary compensation.[89] Later, China introduced liability insurance to incentivize executives to take more risks, and by 2004 stock incentive plans were formally introduced.[90]

In 1986, the Land Administration Law ("Land Law") officially separated property ownership rights from property control rights, creating a market for land use without requiring the state to relinquish ownership over the land.[91] In 1987 and 1988, administrators formalized procedures governing, and fees associated with, the sale and transfer of property control rights. Further regulations followed in 1990 and 1994.[92] Significantly, the officials who had gained bargaining power over their subordinates in the second legal shift now gained power over wealthy investors as well, because investors were better able to bribe officials to gain control of land they might not otherwise be able to access.[93] Relatedly, the directors of Chinese corporate boards have less power than directors of American or French boards because of China's concern that executives managing state assets in SOEs might make decisions that fit business goals rather than national goals.[94] Instead, Chinese shareholders exercise power at the general assembly meeting.

In 2003, the CCP addressed executives' heightened incentives to engage in the real option of collusion by founding the State-owned Assets Supervision and Administration Commission of the State Council ("SASAC"), which "give[s] the impetus to [SOEs] . . . to realize coordinated and sustainable development of enterprises, society and environment in all respects."[95] Further, in 2006, Company Law introduced the fiduciary duties of diligence and loyalty.[96] Company Law was quickly followed by the CRSC Guidelines for Articles of Association of Listed

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[89] *Id*. at 225.

[90] Fidy Xiangxing Hong, *Director Regulation in China: The Sinonization Process*, 19 MICH. ST. J. INT'L L. 501, 522 (2011) [hereinafter Hong].

[91] Land Administration Law (promulgated by the People's Republic of China, June 25, 1986, rev'd Dec. 29, 1988, rev'd Aug. 29, 1998, rev'd Aug. 28, 2004, effective Jan. 1, 1999) available at http://english.mee.gov.cn/Resources/laws/envir_elatedlaws/200710/t20071009_109921.shtml; Pei, *supra* note 84, at 30, 51, 53 (In China, land use rights can be sold without transferring legal ownership of the land.).

[92] Pei, *supra* note 84, at 51-52.

[93] *Id*. at 31-33, 35.

[94] Hong, *supra* note 90, at 513.

[95] STATE-OWNED ASSETS SUPERVISION AND ADMINISTRATION COMMISSION OF THE STATE COUNCIL, GUIDELINES TO THE STATE-OWNED ENTERPRISES DIRECTLY UNDER THE CENTRAL GOVERNMENT (Nov. 2, 2019, 9:58 PM), http://en.sasac.gov.cn/2011/12/06/c_313.htm; Lin Lin, *supra* note 22, at 217 (Executive pay increased by 247% between 2001 and 2011.).

[96] Company Law (promulgated by the People's Republic of China, Dec. 29, 1993, rev'd Dec. 25, 1999, rev'd Aug. 28, 2004, rev'd Oct. 27, 2005, rev'd Dec. 28, 2013, effective Mar. 1, 2014) arts. 147-49, available at http://www.fdi.gov.cn/1800000121_39_4814_0_7.html; Lin Lin, *supra* note 22, at 238; Wei, *supra* note 9, at 172 (The doctrine of good faith takes on a "unique Chinese flavor," as U.S. courts apply the doctrine in a comparatively limited way.).

Companies, which defined the fiduciary duty of diligence, although neither Company Law nor the CRSC Guidelines explain what a director's duties are when setting executive compensation, and directors cannot set their own compensation.[97] In terms of administrative oversight, supervisors in China's two-tier board system (a board of directors operates under a supervisory board, and a CEO can be the chairman of that board) lack the power to make decisions, and instead check for violations of Company Law or the Articles of Association.[98]

While Chinese directors can be held criminally liable for bribery, embezzlement, and misappropriation, the statutory duties of diligence and loyalty are not enforceable laws.[99] This is significant because China has a civil law system rather than a common law system, and its courts cannot establish laws on their own or interpret laws that have not been enacted by statute.[100] Further, it is not clear what compensation China's executives are actually receiving. As of 2015, SASAC sets the base salary for all SOE executives at the same level, including salary, bonuses, pension, health insurance, and housing subsidies, while bonuses and subsidies are variable.[101] However, the compensation disclosed by SASAC may not fully account for a significant component of executive compensation: one study found that executives' on-duty consumption was between two to fifty times greater than their annual compensation.[102]

V. HOW CAN SHAREHOLDERS BE PROTECTED?

While setting executive compensation involves asking how to incentivize executives to act properly, setting shareholder protections involves asking how to prevent executives from acting against

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97 GUIDELINES FOR ARTICLES OF ASSOCIATION OF LISTED COMPANIES (2016 REVISION), CHINA SECURITIES REGULATORY COMMISSION available at http://www.csrc.gov.cn/pub/csrc_en/laws/rfdm/DepartmentRules/201804/P020180427331974952658.pdf; Lin Lin, *supra* note 22, at 233-34, 238-39 (citing Xia Jijun & Zhang Yan, *The Conflicts Between Control Rights and Incentives: An Empirical Analysis on the Effect of Stock Incentives in China*, 3 ECON. RES. J. 87, 97 (2008) (The link between executive pay and performance is weaker when executives are more powerful, and incentives are less impactful when shareholders have more control because SOE shareholders are overwhelmingly state organizations who will re-appoint government executives.)).

98 Lin Lin, *supra* note 22, at 218, 234, 239 (citing P.R.C. Company Law 2006, art. 47(9); P.R.C. Corporate Governance Code 2002, art. 71; P.R.C. Company Law 2006, arts. 38(2) & 47(9)).

99 Hong, *supra* note 90, at 507.

100 *Id*. at 509; Lin Lin, *supra* note 22, at 239.

101 Li-Wen Lin, *supra* note 11, at 33, 45-48, 56 (2018) (SASAC transplants Western pay-for-performance but preserves socialist pay equality.).

102 Lin Lin, *supra* note 22, at 226 n. 97 (summarizing the findings of a study of 1,320 Chinese listed companies by Yang Rong, *Research on Executive Compensation of Listed Companies of Monopolistic Industries—Based on Perquisite Consumption*, 5 FUDAN J. (SOCIAL SCIENCES ED.) 133 (2011)). *See also* Li-Wen Lin, *supra* note 11, at 38.

shareholders' best interests and how to empower shareholders to protect themselves. Instead of balancing incentives to determine what regulations are appropriate, which is done with executive compensation, this inquiry instead defines shareholders' rights, interests, and reasonable expectations, and enumerates executives' legal duties. Shareholder rights are generally enumerated under state and federal law and in a company's charter, although in some contexts companies can create shareholder rights agreements which require shareholders to relinquish legal protections. Further, shareholders in private companies enjoy fewer protections than shareholders in public companies because most countries impose stricter standards on public companies (those that are listed on national stock exchanges and can more easily reach a greater number of potential investors and shareholders).

Shareholders can come in many different forms. Some are private citizens owning a small amount of stock, others are activist hedge funds purchasing controlling blocs, and others are governments, such as France and China. While the presence of a state owner may flip the power dynamic and put the executives in a disadvantaged position compared to the state shareholders, this is not a situation that shareholder protections are meant to address. Further, because shareholders' identities vary, some shareholders are more vulnerable than others and can be harmed by other, more powerful shareholders, particularly those with a control bloc.

Regardless of their relative strength, all types of shareholders tend to rely both on preventative measures (to discourage controlling shareholders, directors, and officers from abusing minority shareholders), and also on remedial measures (to permit shareholders to sue the companies, directors, and officers if their rights are violated or to retroactively vote to reduce pay) for protection. However, each country defines shareholder rights differently and places an emphasis on a different method of shareholder protection (e.g. while France explicitly gives minority shareholders more voting power against executives, the United States provides many opportunities for shareholders to pursue legal action).

VI. THE CURRENT STATE OF SHAREHOLDER PROTECTION IN FRANCE, THE UNITED STATES, & CHINA

As we have seen, France has strong executive compensation laws, the U.S. has moderate executive compensation laws, and China has comparatively weak executive compensation laws. If the hypothesis is correct, then France will have strong shareholder protection laws, the U.S. will have moderate shareholder protection laws, and China will have comparatively weak shareholder protection laws.

a. France

Like American shareholders, most French shareholders have the right to vote in general meetings, to access information, to bring direct or derivative lawsuits, and to receive dividend payments, all of which can be modified and limited by a shareholder agreement.[103] Similarly, French shareholders also cast precatory (rather than binding) votes, and boards must have a high minimum number of independent directors.[104]

However, France has expanded shareholder rights beyond those granted in the United States, giving shareholders in limited liability companies (*société à responsabilité limitée* ("SARL")) and shareholders in stock companies (*société en commandite par actions* ("SCA"), and *société anonyme*) the rights to legally demand answers to questions at general meetings and to challenge board resolutions, even if the challenger is only a minority shareholder.[105] The amount of stock an individual holds is also less important under the French default rules than under Delaware's default rules or U.S. federal law, as each French SARL shareholder, regardless of his or her stock interest, can request that a representative convene a general meeting.[106]

b. United States

As with executive compensation law, both state and federal laws govern U.S. shareholder protection law. Because American corporations overwhelmingly incorporate in Delaware, and because shareholders' rights are established in a company's certificate of incorporation, the DGCL dominates legal debates over U.S. shareholder rights.[107] Notably, American shareholders can give up rights beyond those in a company's charter through a contract known as a stockholders' agreement or shareholders' agreement ("SA").[108]

In general, however, American shareholders operating under Delaware's default rules enjoy one vote per share and vote to delegate the authority to manage the corporation to a board of directors, all of whom are

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[103] Yvon Dréano, *Shareholders' Rights in Private and Public Companies in France: Overview*, Westlaw, 4 (2019) [hereinafter Dréano].

[104] Ass'n Française de Entreprises Privées & Mouvement des Entreprises de France [AFEP-MEDEF], Corporate Governance Code of Listed Corporations, 6-7 (2018) http://www.afep.com/wp-content/uploads/2018/06/Afep-Medef-Code-revision-June-2018-ENG.pdf ("The independent directors should account for half the members of the Board in widely held corporations without controlling shareholders.").

[105] Dréano, *supra* note 103, at 2.

[106] *Id.*; *cf.* DEL. CODE ANN. tit. 8, § 211; SEC Rule 14a-8(b). *See generally* Eleazer Klein, Daniel A. Goldstein, & David M. Rothenberg, *SEC Increases Rule 14a-8 Thresholds*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Oct. 12, 2020) https://corpgov.law.harvard.edu/2020/10/12/sec-increases-rule-14a-8-thresholds/.

[107] *See Annual Report Statistics*, DELAWARE DIV. OF CORPS. (2018) https://corp.delaware.gov/stats/. See generally 8 DEL. CODE ANN. tit. 8, §§ 211-33 (2020) (These sections govern meetings, elections, voting, and notice.).

[108] E.g., PokerTek, Inc. Shareholders Agreement (2004) https://www.sec.gov/Archives/edgar/data/1302177/000119312505157657/dex1015.htm.

reelected after a one-year period and have a fiduciary duty to maximize shareholder wealth.[109] Shareholders have the ability to sue in either a direct or derivative lawsuit when directors fail to uphold this fiduciary duty, but American shareholders largely shoulder the burden of legal expenses.

c. China

China did not establish a stock market until the end of the 20th century, therefore China's shareholder protections laws are less than three decades old.[110] While the *Code of Corporate Governance for Listed Companies in China* was issued in 2001, a 2003 corporate governance report identified problems with the Shanghai stock exchange. Two issues the report brought to light were the lack of protections for minority shareholders and the relative strength of majority shareholders (i.e. state owners) in Chinese listed companies.[111] Since the early 2000s, China has promulgated laws establishing a duty of good faith for controlling shareholders and emphasizing shareholders' right to bring group actions for damages caused by directors' and senior officials' illegal acts.[112] When the Organization for Economic Co-Operation and Development ("OECD") reviewed these and related changes in 2011, the OECD expressed a generally favorable view of the reforms. However, the OECD flagged "curbing abusive related party transactions, enhancing the quality of boards, improving shareholder protection[,] and curbing market abuse" as areas needing improvement.[113] Similarly, research institutions have not come to a consensus regarding the effectiveness of China's shareholder protection laws.[114] This discrepancy is

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[109] 8 DEL. CODE ANN. tit. 8, § 141 (This section covers the board of directors, its powers, number, qualifications, terms and quorum, its committees and classes of directors, nonstock corporations, its reliance upon books, its ability to take action without meeting, and the removal of directors.). See Claire H. Holland, Holly J. Gregory, Rebecca Grapsas, Shareholder Rights and Powers in USA (July 10, 2018), https://www.lexology.com/library/detail.aspx?g=1b53f42b-40df-420e-a54f-8cf522990345.

[110] OECD, *Corporate Governance of Listed Companies in China: Self-Assessment by the China Securities Regulatory Commission*, 9 (2011) http://dx.doi.org/10.1787/9789264119208-en [hereinafter OECD].

[111] Roman Tomasic, Neil Andrews, *Minority Shareholder Protection in China's Top 100 Listed Companies*, 9 Australian J. Asian L. 88, 91, 98, 101 (2007).

[112] *Id.* at 90-92 (citing the Code of Corporate Governance for Listed Companies in China, (promulgated by the Securities Regulatory Committee of the PRC., Jan. 1, 2002) arts. 1-4, 19, ("The controlling shareholders of a listed company shall strictly comply with laws and regulations . . . and shall be prevented from damaging the listed company's or other shareholders' legal rights and interests, through means such as assets restructuring, or from taking advantage of their privileged position to gain additional benefit.")). Gongsi Fa (公司法) [Company Law] (promulgated by the Standing Comm. Nat'l People's Cong. Dec. 29, 1993, revised Oct. 27, 2005) arts. 150, 153 (China).

[113] OECD, *supra* note 110, at 4.

[114] Horace Yeung & Flora Huang, *Shareholder Protection in China from a Numerical Comparative Law Perspective*, 7 CHINESE J. COMP. L. 124, 148 (2019). (explaining why the Cambridge Centre for Business Research ranked China amongst the top performers in

partially due to the fact that China's corporate and financial laws develop quickly, while China's explicit oppression remedies and plaintiff-friendly civil procedure rules develop slowly.[115]

VII. CONCLUSION

This paper explored the hypothesis that when a government regulates the use of real options as compensation, that government is also more likely to have strong shareholder protection laws. This descriptive review of executive compensation laws in France, the United States, and China is consistent with the idea that illicit options are less prevalent where shareholder protections are stronger. Therefore, this paper concludes that the hypothesis is correct. If governments are relying on Crowding Out Theory, this could explain the correlation.

This paper recommends that all countries should consider implementing legislation requiring executive compensation committees to review shareholder protections and to use them as a starting point when setting executive compensation. By placing a greater emphasis on the relationship between shareholder rights and executive interests, meaning that shareholders' actual ability to protect themselves would receive primacy in compensation negotiations, compensation committees could make more holistic decisions that pick up the slack wherever shareholder protections are failing. Compensation negotiations would therefore rely on a modified version of the Crowding Out Theory (under which executive compensation should strike a balance between low pay, which motivates executives to work harder, and high pay, which dissuades executives from pursuing alternative forms of compensation that would harm shareholders) whereby the specific harms shareholders could experience under the charter and shareholder agreement would be reviewed in depth. This would create a direct connection between executive compensation and shareholder rights because, in practice, these two issues are deeply interrelated.

Although neither this measure nor any other would prevent corruption and abuse, it would strengthen minority shareholders' position within a company, effectively giving shareholders a seat in executive compensation discussions. Further, controlling shareholders would not have their interests unduly advanced in this type of negotiation system, as the goal would be to protect the shareholders who are easiest to abuse by analyzing which rights are left unprotected or are being given up through shareholder agreements.

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shareholder protection in 2013, higher than the U.S., while the World Bank's Protecting Minority Investors Index ranked China 119th out of 190 countries: Cambridge studied the principal-agent conflict in listed companies, while the World Bank studied the majority-minority conflict in small or medium-sized enterprises).

[115] *Id*. at 148-49.