AMERICAN APPAREL, CRUMBS CUPCAKES, AND LULULEMON, OH MY! EXAMPLES OF WHY INCREASED SHAREHOLDER INVOLVEMENT WILL NOT FIX CORPORATE AMERICA

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In 2008, the United States experienced the largest financial downturn it had seen since the Great Depression. Some point to excessive compensation as a leading cause of the Financial Crisis, while others blame a lack of shareholder involvement in corporate management. Congress responded by enacting several legislative acts, including the Troubled Asset Relief Program in 2009, and the Dodd–Frank Wall Street Reform and Consumer Protection Act in 2010. These reforms included provisions requiring shareholder "say-on-pay" votes and, more generally speaking, encouraged shareholder engagement and dramatically increased shareholders' influence on corporate decision-making. However, these congressional reforms miss the mark because they fail to address compensation plans that encourage excessive risk-taking. Many believed that giving power to the shareholders would be an adequate solution to this problem. However, based on the current reality of the corporate landscape in the United States, the expectation that shareholders will adequately govern and discipline corporations is doomed to disappoint. This Note argues that the post-Financial-Crisis legislation—specifically, the legislation's push for increased shareholder involvement—fails to adequately fix the problem of excessive executive risk-taking; instead, a deferred compensation model for corporate executives would be a more effective solution for that problem.

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* J.D. Candidate, University of Arizona James E. Rogers College of Law, 2015. I would like to thank Professor Robert H. Mundheim for inspiring me to write this Note, as well as for providing me with his invaluable insight on this topic. A huge thank you to Andrew Hall and Cara Wallace for all of their help on this Note. I would also like to thank Sean Kelly, David Denuyl, Heidi Nielson, as well as the entire *Arizona Law Review* editorial team. Additionally, I owe a special thank you to my amazing, supportive husband, Lowell.

TABLE OF CONTENTS

INTRODUCTION 938

I. THE EMPOWERED SHAREHOLDER—NOT A SUITABLE FIX FOR THE PROBLEM OF SYSTEMIC RISK-TAKING 941

A. The "too-big-to-discipline" CEO 941

B. Shareholder Shortsightedness 945

C. Inadequate Quality Control 947

II. DODD–FRANK'S SAY-ON-PAY—NOT AN ADEQUATE FIX FOR EXCESSIVE EXECUTIVE RISK-TAKING 949

III. SOLUTIONS TO SHAREHOLDER SHORTSIGHTEDNESS—ALIGNING EXECUTIVES WITH INVESTORS' LONG-TERM INTERESTS 950

CONCLUSION 952

INTRODUCTION

Corporate executives, as the "managers of other people's money," ought not to be expected to look after that money with the same degree of care that they would use if their own investments were at stake.[1] Thus, a central concern of corporate governance arises: how can we get managers to do their jobs well based on this reality? There is a long-held belief—at least amongst executives—that high executive salary accurately correlates with an executive's "intrinsic worth" and abilities.[2] And, because people are "highly inclined to exaggerate their own merit," it is safe to say that the average Chief Executive Officer (CEO) believes that he is worth every cent he is paid.[3] Take, for example, former American Express CEO Harvey Golub: he was paid roughly $57 million in salary, bonus, and restricted stock from 1993–2000; he exercised options during that period valued at $92 million; and when he stepped down as CEO, he held options valued at $114.5 million and received an option for an additional 990,000 shares.[4] When asked about his compensation, Golub explained that while he "made a lot of money" and "became wealthy," his "shareholders became wealthier."[5] In fact, Golub was right—during his tenure, American Express's shares increased in value sixfold. However, this is not always the case, as corporate boards largely fail to adequately link CEOs' pay to their performance.[6] For example, public company CEOs receive a large bulk of their pay in stock, but corporate boards typically endow CEOs with

1. *See* Justin Fox & Jay W. Lorsh, *What Good Are Shareholders?*, HARV. BUS. REV. 48, 54 (July–Aug. 2012).

2. See Richard A. Posner, *Are American CEOs Overpaid, and, If So, What If Anything Should Be Done About It?*, 58 DUKE L.J. 1013, 1023 (2009).

3. *See id.*

4. Joann S. Lublin & Scott Thurm, *Money Rules: Behind Soaring Executive Pay, Decades of Failed Restraints*, WALL ST. J., Oct. 12, 2006, at A1.

5. *Id.*

6. *See* Robert J. Jackson, Jr., *Private Equity and Executive Compensation*, 60 UCLA L. REV. 638, 645–46 (2013).

an uninhibited ability to unload that stock.[7] Thus, the current executive compensation scheme does not incentivize executives to focus on a company's long-term financial prospects; rather, it encourages executives to make unduly risky business decisions that maximize stock value in the short term.

Just prior to the Financial Crisis of 2008 ("Financial Crisis"), concern was looming regarding corporate risk-taking and excessive executive compensation—in fact, this concern was articulated in popular culture at least as early as 1936, when President Franklin D. Roosevelt denounced the "entrenched greed" of American corporations' leadership in his State of the Union address.[8] However, unlike the executives of Roosevelt's time who earned a modest $95,000, in the years prior to the Financial Crisis, it was not uncommon for CEOs of publically traded companies to make 179 times as much as a typical U.S. worker—in 2005, for example, the average pay for CEOs of large companies was $10.5 million.[9] There was mounting concern that corporate boards lacked investor accountability, resulting in CEOs getting whatever they could.[10]

The euphoria of a seemingly thriving market caused many to ignore concerns regarding executive risk-taking and compensation.[11] In 2007, Charles Prince, the then-CEO of Citibank, famously stated that he knew the party would end at some point—"When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing you've got to get up and dance. We're still dancing."[12]

The music stopped in 2008—a year that brought with it the largest financial downturn this country had seen since the Great Depression. Some point to excessive compensation as a leading cause of the Financial Crisis, while others blame a lack of shareholder involvement in corporate management. Congress responded by enacting several legislative acts, including the Troubled Asset Relief Program[13] ("TARP") in 2009, and the Dodd–Frank Wall Street Reform and Consumer Protection Act[14] ("Dodd–Frank") in 2010. These reforms included provisions requiring shareholder "say-on-pay" votes and, more generally speaking, encouraged shareholder engagement and dramatically increased shareholders' influence on corporate decision-making. Prior to the Financial Crisis, there was a

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7. *Id.* at 659–60.

8. Lubin & Thurm, *supra* note 4.

9. *Id.* This figure included salary, bonus, and the value of stock and stock-option grants.

10. *Id.*; *see generally* Lucian A. Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833 (2005).

11. Bruce Bartlett, *Who Saw the Housing Bubble Coming?*, FORBES (Jan. 1, 2009, 12:00 AM), http://www.forbes.com/2008/12/31/housing-bubble-crash-oped-cx_bb_0102bartlett.html; *see also* Eric A. Posner & Adrian Vermeule, *Crisis Governance in the Administrative State: 9/11 and the Financial Meltdown of 2008*, 76 U. CHI. L. REV. 1613, 1623 (2009).

12. Michiyo Nakamoto & David Wighton, *Citigroup chief stays bullish on buy-outs*, FIN. TIMES (Jul. 9, 2007, 10:08 PM), http://www.ft.com/intl/cms/s/0/80e2987a-2e50-11dc-821c-0000779fd2ac.html#axzz36iWUaybx.

13. 12 U.S.C. § 5221 (2012).

14. Pub. L. No. 111-203, 124 Stat. 1376 (2010).

strong tradition of shareholders being virtually absent from the corporate decision-making process.[15] Shareholder engagement once was limited to attending analyst conference calls, quarterly-earnings calls, and an annual shareholders' meeting. Now, shareholders often meet one-on-one with representatives of the companies with which they invest, and recently, shareholders have even begun to demand personal interaction with directors.[16]

However, these congressional reforms miss the mark because they fail to address compensation plans that encourage excessive risk-taking.[17] Many believed that giving power to the shareholders would be an adequate solution to this problem. However, as critics Justin Fox and Jay W. Lorsch explain, there is a "gap between rhetoric and reality," and it is that gap, "coupled with waves of corporate scandal and implosion" that has led some to believe that shareholder involvement will solve all of our corporate governance woes.[18] However, based on the current reality of the corporate landscape in the United States, the expectation that shareholders will adequately govern and discipline corporations is doomed to disappoint.[19]

Each spring, prominent corporate governance scholar and University of Arizona James E. Rogers College of Law Professor, Robert H. Mundheim, hosts and moderates a series of informal conversations with national leaders in business and law (the "Mundheim Conversations").[20] The Spring 2014 installment of the Mundheim Conversations explored this new terrain of increased shareholder involvement. These conversations emphasized the need for corporate and executive interests to be better aligned.

This Note builds off the Mundheim Conversations and argues that the post-Financial-Crisis legislation—specifically, the legislation's push for increased shareholder involvement—fails to adequately fix the problem of excessive executive risk-taking; instead, a deferred compensation model for corporate executives would be a more effective solution for that problem. Part I will evaluate

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15. *See Shareholder Engagement: A New Era in Corporate Governance*, CFO JOURNAL (Oct. 4, 2013, 12:01 AM), http://deloitte.wsj.com/cfo/2013/10/04/shareholder-engagement-a-new-era-in-corporate-governance/.

16. *Id.*

17. *See* Jesse D. Gossett, *Financial Institution Executive Compensation: The Problem of Financially Motivated Excessive Risk-Taking, The Regulatory Response, and Common Sense Solutions*, 14 U.C. DAVIS. BUS. L.J. 51, 51 (2013).

18. Fox & Lorsh, *supra* note 1, at 50.

19. *Id.*

20. The Spring 2014 Mundheim Conversations showcased talks with the following prominent business and law leaders: Labe Jackson, Chairman of the JP Morgan Audit Committee; Peter Mundheim, Principal and Counsel of Stone Point Capital; Brandon Becker, Executive Vice President and Chief Legal Officer at TIAA-CREF; and John Cannon, Practice Group Leader of the Executive Compensation & Employee Benefits Group and Chair of the Corporate Governance Advisory Group at Shearman & Sterling LLP. For more information about the Spring 2014 Mundheim Conversations, see *Conversations with Bob Mundheim*, THE UNIVERSITY OF ARIZONA JAMES E. ROGERS COLLEGE OF LAW, http://www.law.arizona.edu/news/news_articles/mundheim.cfm (last visited Aug. 5, 2014).

the shareholder's evolved role following the Financial Crisis, and will argue that this shift in shareholder engagement is not enough to mitigate the many forms of unreasonable corporate risk-taking. Part II will illustrate how increased shareholder involvement is not an adequate fix to what is ailing Corporate America. Finally, Part III will argue that public companies should revise their executive compensation models to comport with the public equity investor model—this is a better solution that would adequately incentivize executives to focus on the long-term goals of the corporation.[21]

I. THE EMPOWERED SHAREHOLDER—NOT A SUITABLE FIX FOR THE PROBLEM OF SYSTEMIC RISK-TAKING

Following the Financial Crisis, the shareholder's role in corporate governance matters has increased exponentially. Generally, prior to 2008, shareholders only participated in corporate governance matters when firms were performing poorly. Even then, shareholder activism was rare—"investors simply did the 'Wall Street walk,' [and sold] their shares if they were unhappy."[22] The Financial Crisis revealed widespread flaws in the former corporate governance framework, and sparked an onslaught of stockholder participation. However, while many thought that an increase in shareholder involvement would be the perfect fix-all for modern corporate governance issues, the results have not been pretty.[23] Today, egregious corporate risk-taking still runs rampant and exists in many forms—rogue CEOs, zealous oversaturation of markets, and inadequate quality control are just a few examples.

Despite an increase in shareholder involvement, boards are still unable to reign in unreasonable CEOs, and companies still fold to shareholder pressure to boost short-term earnings at the expense of long-term value creation.[24] As exhibited by recent corporate governance fiascos, the call for increased shareholder autonomy is ill advised—shareholders by nature are too short-term-oriented to address the corporate risk-taking dilemma, especially now, in an era in which the market is dominated by high-frequency trading.[25] Put simply, shareholders are not well suited to be "corporate bosses."[26]

A. The "too-big-to-discipline" CEO

One of the major governance concerns that the post-Financial Crisis legislation failed to adequately redress is the problem of CEO dominance—the

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21. *See* Emily Chasan, *Early Say-on-Pay Results Show Rising Support, Few Failures*, CFO JOURNAL (April 2, 2014, 4:22 PM), http://blogs.wsj.com /cfo/2014/04/02/early-say-on-pay-results-show-rising-support-few-failures/.

22. *Shareholders at the gates*, ECONOMIST (Mar. 9, 2013), http://www.economist.com/news/business/21573134-americas-proxy-season-will-pit-management-against-owners-never-shareholders.

23. Joe Nocera, *Down With Shareholder Value*, N.Y. TIMES, Aug. 10, 2012, http://www.nytimes.com/2012/08/11/opinion/nocera-down-with-shareholder-value.html?_r=0.

24. *Id.*

25. *Id.*

26. *Id.*

"too-big-to-discipline" CEO who is given too much control over corporate decision-making and, in turn, whom the board fails to rein in.[27] Thus, the CEO is left free to engage in behavior that is contrary to the best interests of the corporation and its shareholders.[28] By the time the problem surfaces, the leadership's fraud, illegal activity, or mismanagement has typically already harmed the corporation and its shareholders.[29] The post-Financial-Crisis legislation has done nothing to address this issue, leaving boards to their own devices.

CEO dominance is particularly ubiquitous for at least three reasons. First, charismatic leaders—the type of leaders highly sought after in the private sector—tend to "run corporate affairs by sheer force of personality."[30] With that said, the personality traits commonly possessed by CEOs, such as "a perpetual knack for arrogance that insults the sensibilities of average folks,"[31] often make them incapable of seeing the flaws in their ideas, strategies, and business plans.[32] Second, because most Fortune 500 corporate boards lack social, cultural, and ideological diversity, they are more prone to "groupthink" and, as a result, are much less likely to adequately identify risk factors and to critique CEO proposals.[33] Third, corporate boards are typically comprised of highly paid executives, including CEOs of other companies—"they have a conflict of interest, since they have a financial stake in high corporate salaries," and because they have a tendency to believe that high salaries equate to executives' inherent worth.[34] These factors tend to construct a business environment where most board members are reluctant to disagree with their CEO.[35] Additionally, there is "evidence of mutual back scratching"—the directors who are approving astronomical CEO pay are often repaid by the CEO's support of their reelection and their own generous pay.[36] The common practice of having the same individual serve as CEO and Chairman of the Board only exacerbates this issue.

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27. *See generally* Labe Jackson, Chair of the Audit Comm. at JPMorgan Chase, Discussion at Conversations with Bob Mundheim (Mar. 24, 2014) (hereinafter "Labe Jackson Conversation") (notes on file with author).

28. Z. Jill Barclift, *Corporate Governance and CEO Dominance*, 50 WASHBURN L.J. 611, 611 (2011).

29. *Id.*

30. *Id.* at 612.

31. Pam Martens & Russ Martens, *Hubris at the Top: The Imperial and Tone Deaf CEO*, WALL STREET ON PARADE (May 21, 2014), http://wallstreetonparade.com/2014/05/hubris-at-the-top-the-imperial-and-tone-deaf-ceo/.

32. Barclift, *supra* note 28, at 618.

33. Tara K. Guinta, *Boardroom Diversity Is Good Corporate Governance*, AM. BANKER (Dec. 11, 2012, 12:00 PM), http://www.americanbanker.com/bankthink/boardroom-diversity-is-good-corporate-governance-1055057-1.html; *see also* Marleen A. O'Connor, *The Enron Board: The Perils of Groupthink*, 71 U. CIN. L. REV. 1233, 1238 (2003); Stephen M. Bainbridge, *Why a Board? Group Decision-Making in Corporate Governance*, 55 VAND. L. REV. 1, 51–54 (2002).

34. Posner, *supra* note 2, at 1024. Posner also highlights the fact that many boards are conflicted because their own executive salaries are partially determined by the salaries paid to those in comparable positions at comparable companies. *Id.*

35. Barclift, *supra* note 28, at 612.

36. *See* Posner, *supra* note 2, at 1024.

On that basis, independent boards—boards that are "free from the dominant CEO whose influence suppresses dissent and discord"—are essential to mitigating the problem of CEO dominance.[37] With that said, identifying a workable way to attain this solution has proven far more difficult to identify—as one commentator explains:

> You have to cut through the smoke and mirrors . . . . There are expansion incentives from landlords, pressure from investors, and there can be an aura of invincibility driven by the ethos of the company founders that fuels expansion and gets retailers into trouble.[38]

The recent developments with American Apparel demonstrate that boards are still unable to manage the risk associated with rogue CEOs, and illustrate how CEO dominance can jeopardize a healthy balance between profitability and risk management.[39] American Apparel's story "begins and ends with Dov Charney";[40] Charney founded the popular fashion brand in 1998 and, from the beginning, acted as its CEO, President, and Chairman. Charney was known in the business world and in the media for "exercising strict, and at times controversial, control over the retailer's operations."[41] In 2002, *PR Week* observed that "[e]verything about American Apparel, including its internal and external public relations practices, has been an organic extension of Charney's beliefs, visions, and personality."[42] Charney managed American Apparel with a "sex sells" strategy—utilizing ads that have recently been criticized as "borderline-pornographic."[43] Further, Charney created American Apparel to be a sweatshop-free, American-made brand, generating a tremendous overhead cost to maintain.[44] However, Charney's questionable leadership was overlooked because his vision for the company resulted in expansion, and "the growth was explosive."[45]

During American Apparel's "boom years," Charney was "praised for his rock-star demeanor," and was celebrated as a "dynamo."[46] During this time, no one

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37. *Id.*

38. Hollie Shaw, *How American Apparel fell into 'dangerous trap' of retail expansion hype*, FIN. POST (Jul. 12, 2014), http://business.financialpost.com/2014/07/12/how-american-apparel-fell-into-dangerous-trap-of-retail-expansion-hype/.

39. *See id.*

40. David Whissel, *CEOs Behaving Badly: A Corporate Governance Case Study of Clothing Retailers*, PROXY MOSAIC 3 (Jul. 16, 2014), *available at* http://54.210.16.161/wp-content/uploads/2014/08/Retail-Company-White-Paper-FINAL2.pdf.

41. *See In re* American Apparel, Inc. S'holder Litig., No. CV 10-06372, 2013 WL 174119, at *1 (C.D. Cal. Jan. 16, 2013).

42. *Id.*

43. *See* Gael O'Brien, *American Apparel: Sex, Power and Terrible Corporate Governance*, BUS. ETHICS (Jul. 2, 2014), http://business-ethics.com/2014/07/02/11827-american-apparel_sex-power-and-terrible-corporate-governance/#printpreview; Whissel, *supra* note 40, at 3.

44. *See generally* Whissel, *supra* note 40.

45. *Id.*

46. *Id.*

questioned whether Charney's antics would later destroy the company.[47] However, American Apparel soon encountered financial hardship as a result of the company's huge overhead and stagnant sales.[48] Further, for years Charney had used corporate money to fend off countless lawsuits—in a recent securities filing, the company listed five arbitration cases brought against Charney and other directors for sexual harassment, assault and battery, impersonation, and defamation.[49]

Charney's leadership was characterized by contradiction. On the one hand, he emphasized the importance of ethical product production within the United States. Yet on the other, his personal ethical scandals and multiple sexual harassment suits tainted the corporation's socially responsible image.[50] Even American Apparel's ethical manufacturing image was mired in scandal: a 2013 class action revealed violations of federal immigration law in its product chain.[51] U.S. Immigration and Customs Enforcement ("ICE") conducted an audit of the corporation's I-9 forms,[52] which resulted in the loss of 2,500 of American Apparel's approximately 3,500 garment manufacturing employees.[53]

As a result of Charney's unchecked power, failed business strategy, and adverse publicity, the company's recent financial picture is gruesome—a 2013 posted loss of $106 million, a dramatic drop in share price from $15 in 2007 to $0.50 in 2014, and threats from the New York Stock Exchange to delist the company unless it begins to conform to exchange standards.[54] Additionally, Allan Mayer, the company's new board co-chair, indicated that Charney's reputation made it very difficult for the company to raise money.[55]

American Apparel has certainly made its mark on popular culture with its affordable, sexually provocative brand. American Apparel broke the rules in a way that won it soaring popularity. But while it is one thing to break the rules, it is quite another to allow the founder to unilaterally write and implement his own.[56] As explained by Professor Thomas White, "the American Apparel sideshow is

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47. *Id.*

48. *Id.*

49. *See* Suzanne Kapner et al., *Inside the American Apparel Revolt*, WALL ST. J. (June 20, 2014, 12:45 AM), http://online.wsj.com/articles/american-apparel-moves-to-fire-ceo-dov-charney-1403191807; Katie Shonk, *Exercising Its BATNA, American Apparel Ousts Dov Charney*, PROGRAM ON NEGOTIATION AT HARVARD LAW SCHOOL (Jul. 23, 2014, 10:58 AM), http://www.pon.harvard.edu/daily/batna/exercising-its-batna-american-apparel-ousts-dov-charney/.

50. O'Brien, *supra* note 43.

51. *See In re* American Apparel, Inc. S'holder Litig., No. CV 10-06372, 2013 WL 174119, at *3 (C.D. Cal. Jan. 16, 2013).

52. I-9 forms are used for identifying and verifying the employment authorization of individuals hired for employment in the United States. For more information, see *I-9, Employment Eligibility Verification*, U.S. CITIZENSHIP AND IMMIGRATION SERVS., http://www.uscis.gov/i-9 (last updated May 8, 2013).

53. *See id.*

54. *See* O'Brien, *supra* note 43; Kapner et al., *supra* note 49.

55. O'Brien, *supra* note 43.

56. *Id.*

simply the latest example of the toxic combination of 'star CEOs' and acquiescent boards."[57] By playing with shareholder money and by compromising the welfare of employees and customers alike, companies like American Apparel "end up operating like grade school playgrounds rather than serious professional organizations."[58] American Apparel is an example of the dilemma faced by many fashion companies whose "founders' creative genius," when left unrestrained, often hinder a successful corporate environment.[59]

The problem of CEO dominance is particularly important because it highlights one of the central governance issues that still remains after the Financial Crisis: Executives are given a substantial amount of power that can often go unchecked by apathetic corporate boards. Whether by strong-arming directors in pay negotiations, or by making unduly risky business decisions, dominant executives can pose huge issues for corporations and the post-Financial-Crisis legislation does nothing to better align these executives' interests with those of their shareholders.

B. Shareholder Shortsightedness

In addition to CEO dominance, shareholder shortsightedness often prompts corporate executives to engage in overzealous risk-taking. Shareholder shortsightedness has prevented the new model of empowered shareholders from achieving its purpose: managing egregious risk-taking by corporate boards and CEOs.[60] There is nothing in the reforms that specifically prohibits corporations from taking excessive risk, and many shareholders in fact prefer that corporations take excessive risks in pursuit of higher short-term gains.[61] Shareholders want, and encourage, companies to take risks; however, sometimes these risks will turn out badly, and when they do, "it will look in hindsight like this was always bad for shareholders . . . ."[62]

Retail markets frequently fall prey to this kind of shareholder pressure, resulting in poor quality and consumer dissatisfaction. For example, recently the popular U.S.-based cupcake chain Crumbs Bake Shop ("Crumbs") announced that it would be closing its doors[63] because management made the mistake of expanding too quickly to appease investors.[64]

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57. *Id.* (quoting Professor Thomas White, Conrad N. Hilton Professor in Business Ethics at Loyola Marymount University).

58. *Id.*

59. *See* Kapner et al., *supra* note 49.

60. *See* Fox & Lorsh, *supra* note 1, at 50.

61. *See* Gossett, *supra* note 17, at 66.

62. *Panel 1: Corporate Governance After the Financial Crisis*, 6 N.Y.U. J. L. & BUS. 171, 177 (2010) (quoting John Coates in the Symposium).

63. Following the announcement, cult followers of the chain were grief-stricken, as evidenced by one Crumbs fan's willingness to shell out $255 for a Crumbs cupcake on eBay. *See* Hayley Peterson, *A Crumbs Cupcake Just Sold for $255 On eBay*, BUS. INSIDER (Jul. 12, 2014, 12:12 AM), http://www.businessinsider.sg/crumbs-cupcake-sells-for-255-on-ebay-2014-7/#.U9Up7JPjmD4.

64. Shaw, *supra* note 38.

Back in 2011, Crumbs had 35 stores, but had its sights set on a much larger market share. Crumbs's CEO told Newsweek that they were "looking to open 200 stores by the end of 2014. I want to be the national neighborhood bakery."[65] In June 2011, a prominent holding company, 57th Street General Acquisition Corp., acquired Crumbs and took it public.[66] Crumbs initially traded as high as $13 a share, but quickly dropped to $3.75 by September 2011 due to the company's widespread financial problems.[67] Despite this plummet in price per share, the company continued pursuing the "questionable strategy"[68] of aggressively opening new locations—reaching 70 stores nationwide by 2013.[69]

In April 2013, Crumbs's stock price had sunk to $1.70 a share and, on July 1, 2014, the cupcake corporation was delisted from NASDAQ for its failure to comply with the minimum stockholders' equity obligation of $2.5 million.[70] As a result of the delisting, Crumbs management feared that the corporation would be unable to satisfy its debts. On July 11, 2014, the corporation filed Chapter 11 Bankruptcy.[71] As one commentator noted, Crumbs "overpenetrated" the market, and probably overestimated demand for its cupcakes—primarily in Manhattan, where the cupcake chain had a whopping 21 locations.[72]

Some have argued that the Crumbs predicament resulted from a "cupcake bubble."[73] However, the more realistic explanation for Crumbs's financial failure is shareholder pressures, since several *privately-owned* metropolitan cupcake chains have not experienced the same troubles. For example, Magnolia, a bakery also based in New York, has just five locations and recently reported to the Wall Street Journal that its same-store sales grew last year.[74] Additionally, the California-based Sprinkles is also doing well—with its 6 stores in Los Angeles, and 17 stores nationally,[75] the cupcake chain recently attracted notable private

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65. Hayley Peterson, *The Rise and Fall of the Crumbs Cupcake Empire*, BUS. INSIDER (Jun. 5, 2014, 2:31 PM), http://www.businessinsider.com/why-crumbs-is-collapsing-2014-6.

66. *Id.*

67. *Id.*

68. Jonathan Maze, *On Crumbs' Crumbling Sales*, RESTAURANT FIN. MONITOR (Apr. 2013), http://www.restfinance.com/Restaurant-Finance-Across-America/April-2013/On-Crumbs-Crumbling-Sales/ (last visited Sept. 7, 2014).

69. *Id.*; *see* Peterson, *supra* note 65 ("The Wall Street Journal would later conclude that Crumbs' downfall was the result of mass "gourmet-cupcake burnout.").

70. Zacks.com, *Crumbs Bake Shop Downs Shutters: End of the Cupcake Era? – Analyst Blog*, NASDAQ (July 9, 2013, 2:20 PM), http://www.nasdaq.com/article/crumbs-bake-shop-downs-shutters-end-of-the-cupcake-era-analyst-blog-cm368843.

71. *Crumbs files for Chapter 11; Lemonis eyes rescue*, USA TODAY (July 14, 2014, 1:50 PM), http://www.usatoday.com/story/money/business/2014/07/14/crumbs-lemonis-cnbc/12633515/.

72. Maze, *supra* note 68.

73. *Id.*; *see* Peterson, *supra* note 65.

74. Maze, *supra* note 68.

75. *Locations*, SPRINKLES, http://www.sprinkles.com/locations (last visited Jul. 29, 2014).

equity firm Karp Reilly, which has a good track record of making restaurant investments.[76]

The Crumbs situation, "cupcake bubble" or not, is emblematic of the idea that public markets and investors are largely concerned with growth, and "they constantly hammer on management to open more stores," which results in specialty retail stores expanding too fast in attempt to satisfy the shareholder demands—rather than focusing on satisfying the market demand for their product.[77]

As exhibited above, the post-Financial-Crisis legislation does nothing to solve the problem of shareholder shortsightedness and the subsequent pressures it exerts on corporate boards. Shareholders are often too focused on short-term results, and tend to overlook the importance of corporations' long-term health. Increased shareholder involvement only magnifies this problem—as exhibited by the tragic demise of Crumbs. Thus, corporations must find a way to refocus management's attention to their long-term needs.

C. Inadequate Quality Control

Board members walk a very fine line between meeting their fiduciary duties to shareholders in maximizing profit on the one hand, and adequately managing risk on the other.[78] Especially in conjunction with the widespread shareholder focus on short-term gains, it is not surprising that corporate decision-makers' risk management tends to fall short, even when the risk is anticipated.[79]

Popular athletic wear manufacturer Lululemon is another example of how poor risk management can sabotage an otherwise extremely popular and profitable brand. Lululemon recently struggled to respond to product quality issues and failed to contain the subsequent fallout. Through grassroots brand development and a business strategy of "planned scarcity,"[80] the Canadian clothing manufacturer developed a brand so strong that it generated annual sales per square foot of $2,000—a notably high figure for retail, and the third-highest in the United States after Apple and Tiffany & Co.[81] In December 2012, Lululemon issued its earnings for the third quarter of 2012 and reported a 37% net increase in revenue, which then-CEO Christine Day assured was not the result of a "growth at any cost" business model.[82] However, as a former IT Quality Assurance Manager at the

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76. Maze, *supra* note 68.

77. Shaw, *supra* note 38.

78. Labe Jackson Conversation, *supra* note 27.

79. David F. Larcker et al., *Lululemon: A Sheer Debacle in Risk Management*, STANFORD CLOSER LOOK SERIES 1, June 17, 2014, *available at* http://public-prod-acquia.gsb.stanford.edu/sites/default/files/41_Lululemon.pdf.

80. Introduced by former CEO Christine Day, this strategy was implemented by keeping key products in short supply in order to bolster demand. *See id.*

81. *Id.*

82. *In re* Lululemon Sec. Litig., No. 13 Civ. 4596, 2014 WL 1569500, at *4 (S.D.N.Y. Apr. 18, 2014).

Lululemon headquarters testified, "Day stated to employees that the company's growth had led to a sacrifice in quality."[83]

In March 2013, Lululemon was forced to pull approximately 17% of its inventory of women's pants from its shelves because the fabric was too sheer.[84] The repercussions of this decision were ugly, from securities fraud allegations to shareholder derivative suits to scathing reviews on social media. However, what is particularly noteworthy about the Lululemon sheer-pants debacle is that the company had filed a 10K form with the Securities Exchange Commission on March 22, 2012, warning of its reliance on a limited number of suppliers.[85] Lululemon recognized that a supply chain issue could be detrimental to its operations.[86] In short, it knew the risks and ignored them.

For Lululemon, maintaining high product quality was essential to the company's ability to maintain the value and reputation of its brand. Thus, the impact of the product recall was devastating, resulting in an alleged diminution in sales revenue of $40–45 million for the first half of 2013 alone.[87] But as litigation would later reveal, this was not the first time Lululemon had encountered serious quality failures.[88] For instance, in 2007, it claimed that its "Vitasea" line of apparel contained "marine amino acids" that would reduce wearers' stress.[89] Shortly thereafter, *The New York Times* uncovered inaccuracies in the company's claims, prompting Lululemon to admit that it had not even tested the Vitasea products, but rather had blindly trusted its suppliers' claims.[90] Again in 2010, the company's shopping bags were printed with ink that contained high lead content.[91] And yet again in 2011 and 2012, the company received complaints of color dye bleeding from customers' clothing during exercise, causing health concerns.[92] Further, despite the company's recognition of potential quality-control issues prior to 2012, founder and former Chairman Chip Wilson attempted to shift blame to the consumer in claiming, "some women's bodies just actually don't work for

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83. *Id.*
84. Larcker et al., *supra* note 79.
85. *Id.*
86. The exact language was as follows:

> We may experience a significant disruption in the supply of fabrics or raw materials from current sources . . . . Additionally, if defects in the manufacture of our products are not discovered until after such products are purchased by our guests, our guests could lose confidence in the technical attributes of our products and our results of operations could suffer and our business could be harmed.

Lululemon Athletica, Annual Report (form 10-k) (March 22, 2012); *see* Larcker et al., *supra* note 79.

87. *In re Lululemon*, 2014 WL1569500, at *2.
88. *Id.*
89. *Id.*
90. *Id.*; Louise Story, *'Seaweed' Clothing Has None, Tests Show*, N.Y. Times (Nov. 14, 2007), http://www.nytimes.com/2007/11/14/business/14seaweed.html?pagewanted=print&_r=2&.
91. *In re Lululemon*, 2014 WL1569500, at *3.
92. *Id.*

(wearing Lululemon pants) . . . it's really about rubbing through the thighs, how much pressure is there over a period of time . . . ."[93]

Lululemon's initial success was unprecedented—after all, it is not easy for $90 yoga pants to generate a cult following. Despite this success, *Huffington Post* recently reported that the brand is likely to disappear in 2015.[94] This prediction is due to the company's mishandling of the 2013 recall, quality issues, and a number of public relations failures. The rise and fall of Lululemon illuminates the fact that inadequate risk-management is still prevalent, and that it can be the Achilles' heel of even the most successful corporations.

The three recent corporate governance blunders above illustrate how Dodd–Frank did not fix many major issues with corporate governance in the United States. Following the post-Financial-Crisis legislation, many corporate boards are still unable to reign in risky liabilities such as rogue CEOs; they still possess a get-rich-quick ideology that manifests in the form of oversaturation and overexpansion; and they are still struggling to manage risk, even when it is foreseeable.

II. DODD–FRANK'S SAY-ON-PAY—NOT AN ADEQUATE FIX FOR EXCESSIVE EXECUTIVE RISK-TAKING

As the above examples illustrate, something has to be done to increase executive accountability for overzealous risk-taking and to address beyond-the-pale CEOs. The corporate governance reforms of the bailout legislation and Dodd–Frank aimed to address self-interested managerial decisions, specifically those that dealt with executive compensation.[95] One of the primary reforms was "say-on-pay," which is a nonbinding shareholder vote on executive compensation.[96] Say-on-pay was essentially a response to mounting public outrage over executive compensation. This movement stemmed from a belief that executive pay was (and still is) insufficiently tied to corporate performance, and from a concern about the widening gap between executive compensation and the pay of average workers.[97] President Obama's "rhetorical assault" on executive bonuses as "shameful" is one example of this post-Financial-Crisis narrative on executive pay.[98] Some have even

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93. *See* Ian Austin, *Lululemon founder Chip Wilson paying the price for saying yoga pants 'don't work' for some women's bodies*, PROVINCE (June 22, 2014), http://www.theprovince.com/Lululemon+founder+Chip+Wilson+paying+price+saying+yoga+pants+work+some+women+bodies/9951155/story.html; Whissel, *supra* note 40, at 5.

94. Douglas A. McIntyre, *10 Brands That Will Disappear In 2015: 24/7 Wall St.*, HUFF. POST (Jul. 15, 2014, 11:59AM), http://www.huffingtonpost.com/2014/07/12/brands-disappearing-in-2015_n_5580761.html.

95. *See* Dodd–Frank Wall Street Reform and Consumer Protection Act, 15 U.S.C. § 78n-1 (Supp. 2011); Usha Rodrigues, *Corporate Governance in an Age of Separation of Ownership from Ownership*, 95 MINN. L. REV. 1822, 1839 (2011).

96. 15 U.S.C. § 78I (2012).

97. Lisa M. Fairfax, *Sue on Pay: Say on Pay's Impact on Directors' Fiduciary Duties*, 55 ARIZ. L. REV. 1, 3 (2013).

98. Sanjai Bhagat & Roberta Romano, *Reforming Executive Compensation: Focusing and Committing to the Long-Term*, 26 YALE J. ON REG. 359, 360 (2009) (citing

gone so far as to blame the entire Financial Crisis on excessive executive pay, which they maintain incentivized executives to make unjustifiably risky business decisions.[99] Proponents of this view believe that the Financial Crisis was caused by systemic risk arising from corporations' failure to internalize long-term dangers that inevitably resulted from their conduct.[100] These proponents argue that increased shareholder participation will mitigate the problem of myopic directors.[101]

In 2009, the federal government began mandating say-on-pay for corporations that were receiving funding under TARP.[102] In 2010, Dodd–Frank extended say-on-pay to all public companies.[103] But say-on-pay is not a panacea. Indeed, as opponents have noted, given the shortsightedness of many shareholders, the say-on-pay mandate could very well create a scheme that actually *encourages* short-term risk—further exacerbating the problem at hand.[104] Thus, given the current investment landscape, a reliance on shareholders to combat greedy management is "all but incoherent."[105] Additionally, the post-Financial-Crisis legislation largely focuses on pay levels rather than pay-performance link and, as a result, discourages directors from pursuing the maximization of a company's long-term value.[106]

III. SOLUTIONS TO SHAREHOLDER SHORTSIGHTEDNESS—ALIGNING EXECUTIVES WITH INVESTORS' LONG-TERM INTERESTS

It is in the public's interest for firms to be focused on the long-term—stable corporations go hand-in-hand with a stable economy. Thus, increased shareholder involvement is not the solution because, as articulated above, shareholders tend to only care about companies' short-term gains.[107] As Mundheim Conversations speaker John Cannon discussed, many believe that rather than limiting compensation to a dollar amount, deferred compensation would be far more effective in incentivizing executives to manage risk in a way that benefits investors long-term.[108] For example, Judge Richard Posner points out that the current stock-option method used to compensate CEOs induces them to make risky

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Aaron Lucchetti & Matthew Karnitschnig, *On Street, New Reality on Pay Sets In*, WALL ST. J., Jan. 31, 2009, at B1).

99. *See* Rodrigues, *supra* note 95, at 1823.

100. *Id.*

101. *Id.*

102. 12 U.S.C. § 5221 (2012).

103. Fairfax, *supra* note 97, at 4.

104. Rodrigues, *supra* note 95, at 1824.

105. *Id.* at 1842.

106. *See* Rodrigues, *supra* note 95, at 1823.

107. *See id.* at 1823.

108. John Cannon, Practice Group Leader of the Executive Compensation & Employee Benefits Group and Chair of the Corporate Governance Advisory Group at Shearman and Sterling LLP, Discussion at Conversations with Bob Mundheim (April 7, 2014) (on file with author); *see also* Posner, *supra* note 2, at 1045–46; Bhagat & Romano, *supra* note 98.

business decisions because of "the asymmetry of gain and loss: there is no ceiling on the potential gain, but the loss is truncated at the value of options."[109] Judge Posner also notes that, sometimes, CEOs experience no loss at all because options are "repriced," which enables CEOs to exercise options at a profit even when a corporation's stock price has fallen well below the original exercise prices. This creates a huge incentive for executives to engage in excessive risk-taking because the gains are endless, and even if they drive the company into the ground, they will still receive a huge payout—thus, "the alignment between the CEO's interests and those of the shareholders is broken."[110] Judge Posner proposes a reform that backloads a substantial share of executive compensation, and ties compensation to the future performance of the firm.[111] Posner argues that this reform would combat the dangerous incentive of highly compensated CEOs and executives to maximize short-term corporate profits and take undue risks with the corporation's assets in order to secure their own annual performance bonuses.[112]

Some take this notion a step further, suggesting that there should be a move towards executive incentive compensation plans that consist *only* of restricted stock and restricted stock options that cannot be exercised for at least two to four years after the executive's resignation or last day at the office.[113] Professors Sanjai Bhagat and Roberta Romano advocate for this scheme, arguing that this form of equity-based compensation would provide executives of publicly traded corporations with the "proper incentives to operate the business in investors' and society's interest."[114]

Along the same lines, the executive pay structure implemented by private equity investors would also serve effectively to strengthen the pay-performance link in the public sector, and lessen incentive for executives to make overly risky decisions. Professors Robert J. Jackson, Jr. and David I. Walker both advocate for an executive pay structure in the public realm that mirrors the structure of executives in the private equity domain.[115] All things considered, this would be a workable model for deferred executive pay in public companies because CEOs would then have a long-term, vested interest in the success of their companies.

The Mundheim Conversations highlighted that the structure of executive compensation for private equity investors' portfolio companies is particularly effective in aligning executive interests with the fund's objectives. Peter Mundheim, Principal and Counsel for Stone Point Capital, illustrated that there is a mindset amongst executives that "what is good for the fund is good for everyone."[116] The structure of private-equity executive pay also mirrors the deferred compensation model in that executives receive illiquid equity

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109. Posner, *supra* note 2, at 1026–27.
110. *Id.* at 1027.
111. *Id.* at 1045–46.
112. *Id.*
113. Bhagat & Romano, *supra* note 98.
114. *Id.*
115. *See generally* Jackson, *supra* note 6; David I. Walker, *Executive Pay Lessons from Private Equity*, 91 B.U. L. REV. 1209 (2011).
116. Peter Mundheim, Principal and Counsel, Stone Point Capital, Discussion at Conversations with Bob Mundheim (Mar. 31, 2014) (on file with author).

compensation that must be held until a "liquidity event," such as an initial public offerings or sale of the company to another private-equity investor.[117] This differs from the current public company structure because, even though public company CEOs receive most of their pay in stock rather than cash, they are allowed to "unload" (or sell) their stockholdings—something private-equity firms strictly prohibit, rendering the pay-performance link much stronger in portfolio companies owned by private equity investors.[118] Moreover, CEOs of private equity portfolio companies are required to contribute capital to the fund's venture—on average, portfolio-company CEOs hold 64% more equity than CEOs of comparable public companies.[119] These limitations result in directors of companies owned by private-equity firms having a stronger motivation to maximize shareholder value and, in turn, a stronger pay-performance link.[120] Additionally, this type of pay scheme provides more motivation to maximize shareholder value because executives' pay will undoubtedly fluctuate with a company's value. [121]

Currently, despite directors' official duty to advance shareholder interests, directors often make decisions that are not in the best interest of shareholders.[122] Corporate boards of public companies inherently have reason to favor executives' interests over shareholder interests when setting executive compensation. The private-equity compensation model would eliminate this conflict because CEOs would no longer personally benefit when directors concede to offers that are not in the shareholders' best interest.[123] Thus, the private-equity model creates an "unconflicted motivation to maximize shareholder value," and adequately mitigates that problem of excessive executive risk-taking.[124]

CONCLUSION

Given the terrain of the American corporate world, and the pervasive need to align corporate executives' interests with the company's long-term interests, the increased shareholder involvement Dodd–Frank prescribes is not a proper fix for the problem of excessive executive risk-taking. As exhibited by the aforementioned case studies, the problem of unreasonable executive risk-taking is still hugely prevalent, and has resulted in the near-demise of many popular, heavy-hitting corporations. In order to mitigate this systemic risk, public companies should restructure their executive compensation models to mirror the public equity model—a model that has proven to provide directors with an unconflicted motivation to avoid unreasonable risk-taking, as well as to maximize shareholder value.

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117. Walker, *supra* note 115, at 1218.

118. Jackson, *supra* note 6, at 640.

119. Walker, *supra* note 115, at 1218–19. Walker cites to data from a study by Philip Leslie and Paul Oyer, which indicates that portfolio company CEOs hold 2.3 percentage points more equity than CEOs of similar public companies—equating to a 64% difference.

120. Jackson, *supra* note 6, at 668.

121. *Id.* at 645–46.

122. *Id.* at 641.

123. *Id.*

124. *See id.*