9

EXECUTIVE COMPENSATION

9.1 Introduction

Viewed from a great height, corporation law can be seen to have two main social goals. The first is the facilitation of cooperative economic activity. This goal is advanced by all of the fundamental features of the corporate form that we discussed in Chapter 3 — for example, powerful centralized managers appointed by the shareholder-elected board. The second great aim of corporate law is the efficient reduction of agency costs in this powerful managerial institution. This is especially true for companies that raise equity through public distribution of their shares. We say the *efficient* reduction of agency costs because steps taken to reduce managerial discretion may reduce not only agency costs but may also reduce the effectiveness of management as well. In theory, it is possible in reducing agency costs to have "too much of a good thing."

The enforcement of the fiduciary duty of loyalty in derivative litigation is directed towards this second aim. But enforcing legal duties in court is a costly, *ex post*, and highly imperfect way to get senior managers to act in an appropriate way. An *ex ante* approach — that is, an approach that creates incentives for managers to work diligently to increase long-term corporate (and shareholder) wealth — would, if feasible, obviously be better. Such incentive systems are in fact widely used; they primarily are embedded in the corporations' compensation structures. Establishing or approving them is one of the principal functions of modern corporate governance.

But designing compensation systems that effectively link managers' personal interests with corporate wealth production is an extremely complex, and inherently imperfect activity. First, it is difficult to identify the best signals of "production." Among the many possibilities here are earnings per share, stock price, sales or revenue, or more complex departmental or product oriented metrics. Second, even if measures of production can be identified, attributing that production to individual members of the management team is complicated. Most production in firms is inevitably team production. Third, selecting the time-frame over which production is to be measured is itself problematic. Investors naturally think in terms of quarterly or annual returns. But firms in different industries and with different challenges embedded in their environments may plan in shorter or longer cycles and measurement might optimally differ among them. Fourth, whatever metric is chosen over whatever time-frame, those who will be paid in relation to it will have incentives to "game" the system, i.e., managing to maximize the metric rather than overall corporate performance. Even worse, as some of the corporate scandals of the past few years illustrate, managers might use guile or deception in order to maximize the metric.

These challenges are the central focus of this Chapter. We also address the academic debate concerning how well public-company boards are in setting these incentives (judged by the results the incentives generate) and the regulatory responses to the problems associated with setting compensation. Finally, we address the necessarily quite limited role that judicial review can and does play in reviewing the results of corporate compensation plans both for senior executives and for corporate directors themselves.

9.2 The Challenge of Executive Pay

In their business decisions, senior executives may have a tendency to act somewhat conservatively. Their position at the firm is very valuable to them and if the firm should fail, they suffer great personal loss. Investors, on the other hand, can easily and cheaply diversify the risk of firm failure. For officers or employees, that hedge is not available. Thus, senior officers can be expected to assume less risk concerning the firm than diversified shareholders may prefer. Incentive compensation plans are the widely adopted strategy to try to better align the economic interests of the executive team with those of diversified shareholders. We touch upon the difficulty of this design task above. But we should also mention a foundational challenge of stock-based incentive compensation plans (including options and restricted stock and phantom stock rights). It lies in creating incentives for senior executives to act energetically to advance shareholder interests by assuming risk intelligently, but to not overdo it. That is, not to induce them to take excessive risk with the firm's assets.

9.2.1 Creating Incentives That Align Managers with Investors

In the 1970s and 1980s, CEOs and other top executives were, for the most part, compensated like all other employees of the company, with most of their compensation coming in the form of an annual salary, and then an additional, discretionary bonus paid at the end of the year.The only difference between the CEO and other employees was that the CEO's pay would be set by the board of directors; then the CEO would be responsible, directly or indirectly, for setting the pay for all other employees. During this era, the level of CEO pay was only occasionally controversial; rather, most of the criticism focused on the way in which CEO's were compensated. In 1990, Professor Michael Jensen made the point sharply that CEOs had inadequate financial incentive to maximize value for their shareholders: "CEO's are compensated like bureaucrats" was his famous claim. If the company did well, the CEO didn't get much more money; and if the company did poorly, he didn't seem to feel it very much. The correlation between CEO compensation and overall firm performance was low.[1]

One implication of this observation was the potential for larger agency costs of management. If the CEO received a trivially small fraction of any benefits created for the corporation, and suffered only a trivially small fraction of any costs imposed, would he not, for example, be more likely to approve investing in a corporate headquarters palace, rather than a more utilitarian headquarters building? Would he work 24/7 or might he leave the office at 3:00 p.m. some afternoon to play golf? Famous stories, such as RJR Nabisco CEO Ross Johnson flying his dog on the corporate jet at large expense to the corporation, fueled the popular perception during this era that the "private benefits of control" for public-company CEOs were large. Jensen and others argued that the particular compensation system that was commonplace during this era increased agency costs, at the expense of shareholder wealth maximization and overall corporate value.

Business owners had always understood the importance of creating incentives for important employees. Stock options, for example, became an accepted part of executive pay by the early 1950s. Still, Professor Jensen's criticism was that the levels of these incentives were far too small. By the 1990s, the more high-powered performance-based pay began to broadly emerge. Although several metrics could have been used to measure performance, such as revenue growth, earnings growth, or subjective assessments, corporate boards during this era gravitated primarily to stock performance as a measure of CEO productivity. Stock-based pay is straightforward: In addition to an annual salary and bonus, the CEO would at the beginning of a pay cycle receive a specified number of shares or options on the shares of the company. If the company did well, the CEO's stock would appreciate in value. Only slightly less intuitive is option-based compensation. A stock option in this context (technically a ''call'' option) is the right to purchase a share of stock from the company for a fixed price, known as the "strike price" of the option. If the strike price is the market price of the stock at the time the grant is made, as is normally the case, the option is an "at the money" option. If the strike price is lower than the current market price, the option is granted "in the money." And if the strike price is higher than the current market price, the option is granted "out of the money."

To take a simplified example, a company might grant its CEO the right to buy 100 shares of XYZ Corporation at the current share price of $100 per share. Typically, the option would have a ten-year exercise period (which is longer than exercise periods for options that trade in the financial markets), which means that if the share price of XYZ Corporation went above $100 (say, to $110), the CEO could exercise his right to buy 100 shares of the company at $100, and then sell those shares into the marketplace at $110.

1. See, e.g., Michael C. Jensen & Kevin J. Murphy, *Performance Pay and Top-Management Incentives*, 98 J. Pol. Econ. 225 (1990) (calculating that CEOs receive, on average, $3.25 for every $1,000 increase in shareholder wealth).

In this example, the CEO would make a profit of $10 per share × 100 shares = $1,000. If, instead, the share price of XYZ Corporation stayed at or below $100 for the full ten-year exercise period, the CEO would have no incentive to exercise the options, and the options would expire unexercised.

There are variants on this basic model. "Restricted stock" plans make grants of actual shares of stock that vest over a certain period, typically three years. The executive obtains title to the stock only after certain conditions have been met, typically continued employment, but occasionally, hitting certain performance targets as well. "Cliff vesting" stock vests all at once—for example, after continued employment for three years. "Pro rata vesting" stock vests over time—for example, one-third of the stock grant vests each year, for three years. The general idea of restricted stock, of course, is to create incentives for managers to act in the long-term best interests of the corporation. For example, a management decision that might create a quick but temporary upward tick in the company's stock price might be tempting for a manager who holds stock or stock options in the company, unless the stock or options only vest over some longer period of time.[2]

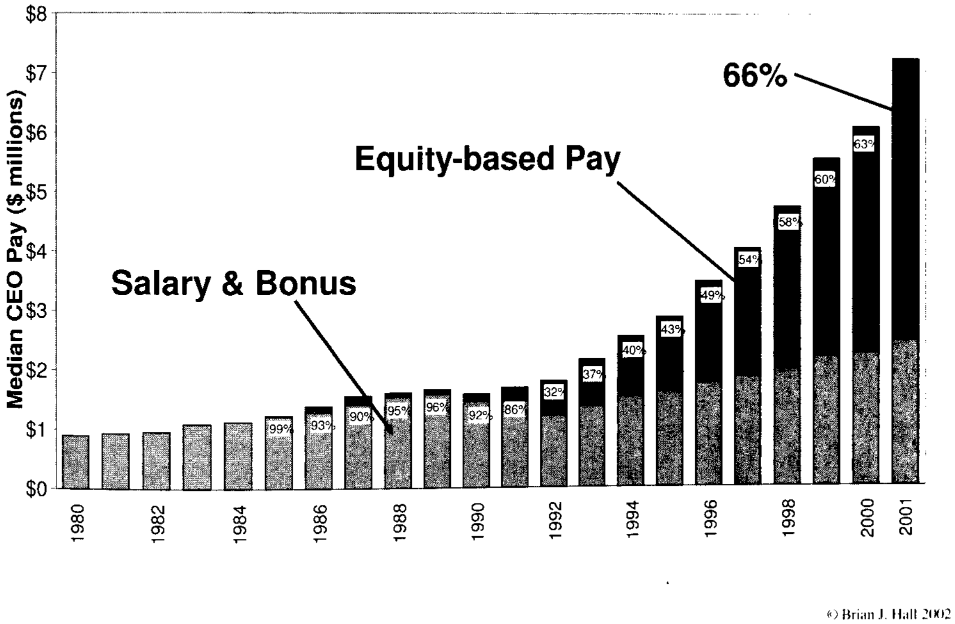
Stock and stock-option compensation (collectively, "performance-based pay") exploded during the 1990s. The following chart documents the growth of CEO pay during this period and the dramatic shift to performance-based pay, going from very little in 1980 to approximately two-thirds of total compensation for the median CEO by 2001. The chart shows that while salary grew during the period, the greatest part of growth in CEO pay was in the value of share-based incentives, the rise of which reflected in part a general rise in stock market prices across the economy as a whole during those years.[3]

Stock markets don't always rise, of course, and when the stock of any company falls enough, its options will lose some of their incentive effect. When this occurred in the 1990s, some firms undertook to "reprice" option strike prices by resetting the strike price to something closer to current market. It was thought that the options would recapture the incentive effect that they were designed to create. Of course, this represented a windfall to executives, because their previously "out of the money" options now became substantially more valuable "at the money" options. Critics of this practice pointed out that if executives expected options to be repriced, then the link between pay and performance had been severed.[4]

2. There is also "phantom stock," which provides a cash or stock bonus based on the stock price at some future date. If structured properly, phantom stock creates the same economic incentives for the manager as actual stock.

3. Indeed, that points out one of the major weaknesses of stock as a metric for senior officer productivity. While the performance of senior officers is critically important to the firm, stock price itself will reflect many things unconnected with their performance, i.e., the Federal Reserve Board's interest rate policy, just to name the most obvious factor.

4. Yet another pay practice that diluted the incentive effect of stock-option compensation was option "reloading." With reload options, once an executive had exercised her options, she would get the same number of new options, struck at the current market price. Of course, reload options created incentives to "ratchet up." Each time the stock price blipped upward, executives might exercise their vested options and then receive new options struck at the new market price. This practice has largely disappeared under institutional investor pressure.



9.2.2 Political and Regulatory Responses to Executive Pay

Clearly, some of the trend towards stock-based pay was influenced by pay experts, directors, and other observers who sought to establish a tighter link between pay and performance. But other factors also were at work in explaining the shift to performance-based pay. Indeed, action by both political and regulatory organs of government has had an important effect in both the modern structure and level of executive pay, albeit not always the intended effect.[5]

Perhaps most importantly, in 1993, in response to perceived general unhappiness with high CEO pay, Congress passed §162(m) of the Internal Revenue Code, which stated that compensation above $1 million for the CEO and any of the other four top officers would not be deductible to the corporation for income tax purposes unless it was "performance-based compensation." Stock and stock-option compensation clearly qualified as "performance-based compensation," and therefore avoided the $1 million cap. Corporate

5. The effect, sometimes perverse, of government regulation on the level and structure of executive pay is an understudied aspect of this subject, according to some leading scholars. See, e.g., Kevin Murphy, "Executive Compensation: Where We Are and How We Got There," in Handbook of the Economics of Finance, edited by George Constantinides, Milton Harris, and René Stulz (Elsevier Science North Holland 2013).

boards responded to this change in law by increasing the proportion of stock or option-based compensation in the pay packages of senior officers.

Boards liked stock-based compensation for accounting reasons as well. Unless they were "in the money" at the time of the grant (which was rare), stock options *were not an expense* to the company under applicable accounting rules.[6] Therefore they did not reduce closely watched performance metrics such as earnings per share (EPS) and price-earnings ratios. In an efficient market, of course, accounting treatment of options should not matter to stock price because investors should "see through" accounting rules to understand that CEOs were taking value out of the company through stock options. In the real world, however, investors seemed to care about accounting measures, and boards, in turn, seemed to view stock-option compensation as a cheap tool for compensating the CEO, relative to salary, bonus, or stock — but this changed. In 2004, FASB Statement No. 123 was issued, which required companies to expense the "fair market value" of options at the time of grant.[7] But until then, it is no exaggeration to say that many boards viewed stock options as essentially a "free" way to compensate the CEO.[8]

Ironically, other regulatory measures played a role in rising CEO pay. Also in 1993, the SEC established new rules requiring corporations to make far more detailed public disclosures about the compensation of their top five corporate officers. Three elements were particularly noteworthy. First, companies had to disclose, in a standardized Summary Compensation Table, the annual compensation (salary, bonus, etc.), long-term compensation (restricted stock awards, option awards, etc.), and all other compensation for the top five employees in the company. Second, the 1993 reforms required a narrative description of all employment contracts with top executives, and disclosure of a Compensation Committee report explaining the committee's compensation decisions. Finally, the reforms required a graph showing the company's cumulative shareholder returns for the previous five years, along with a broad-based market index and a peer-group index for the same period.

6. Those rules, Generally Accepted Accounting Principles, (GAAP) are promulgated by FASB (Financial Accounting Standards Board) which is the private body charged by the SEC with their development.

7. Although Rule 123 does not require a specific method for valuing the options, the vast majority of U.S. companies have used the Black-Scholes option pricing formula. Critics complain that the Black-Scholes formula overstates the value of options on the income statement; among other reasons, the Black-Scholes formula assumes that the option-holder is perfectly diversified, which is not the case for managers who are over-invested in their own companies. Even if their financial portfolios were perfectly diversified, managers' "human capital" is invested 100 percent in the company, and cannot be diversified.

8. The New York Stock Exchange and NASDAQ listing standards now require listed companies to seek shareholder approval for *all* stock-option plans except those that are offered as an inducement to new employees or in connection with a merger or acquisition. See www.nyse.com/pdfs/finalruletext303A.pdf; nasd.complinet.com/nasd/display/index.html (Rule 4350-5). Formerly, the NYSE and NASDAQ excluded "broadly based" option plans from required shareholder votes. In addition, all issuers must obtain shareholder approval of stock-option plans in order to qualify for favorable federal tax treatment, including exemption from the limits on deductibility under §162(m) of the IRC and special tax treatment for incentive stock options (ISOs).

The net effect of these reforms was increased transparency. Here is the irony: These additional disclosures, rather than dampening CEO compensation, seem to have had the opposite effect. This was due to the particular way in which CEO pay is set. Typically, the compensation committee of the board will hire a compensation consultant, who then identifies a set of comparable companies. Beginning in 1993, the consultant would have excellent visibility of the pay of the top executives at these comparable companies. Using this information, the consultant would prepare a report for the compensation committee. Typically, compensation committees would want to pay their CEO at roughly the 75th percentile among comparable companies, reflecting the fact that their CEO is (of course) above average. But if all boards are aiming to pay their CEO at the 75th percentile, then we get a general ratcheting up of CEO pay levels along the lines of what is documented in the chart above. The 1993 disclosure requirement fueled this trend by creating greater visibility on the pay of (arguably) comparable CEOs.

The public perception problem grew worse. In July 2001, *Fortune* magazine, led with a cover story entitled "Inside the Great CEO Pay Heist" and added for good measure: "Why the madness won't stop." In October 2003, the cover story in *The Economist* lamented, "Where's the stick? The problem with lavish executive pay." According to their editors: "CEO's are selected for their cleverness and determination, and they have directed these qualities at boosting their own pay. The more the public spotlight is thrown on one aspect of bosses' remuneration, it seems, the more it rises elsewhere."

Given the way CEO pay is structured today, rising stock markets mean rising pay. CEO pay thus grew dramatically with the market. In 2006, the SEC returned to the issue of executive compensation. As in 1993, the focus of the 2006 reforms was increased disclosure of executive compensation. The new SEC rule required a single number that captures all compensation for each of the top executives, as well as improved disclosures on retirement payouts, perquisites, directors' pay, and related-party transactions. We noted that structuring incentive pay was a delicate problem requiring balance. The risk of overstimulating risk acceptance came to the fore in the financial crisis of 2008. Some commentators argued that the massive turn to incentive compensation in the banking and finance industries especially — not just at the most senior executive level but throughout the firms — added fuel to the financial crisis by encouraging executives to make excessively risky investments. If these investments paid off, the stock price or other metric of their performance would go up. They might become wealthy, or at least wealthier, overnight. But they personally had no capital at risk in their trades, so if the investments didn't pay off the corporation would lose, the stock price would fall, and while they would make nothing from that trade or for that year, it would be shareholders and (perhaps) creditors who would experience the full downside consequences. In this analysis, the highly leveraged investments that seemed excessively risky in hindsight were the inevitable consequences of sophisticated managers responding rationally to their compensation systems. In response to Professor Jensen's criticism of low-powered pay practices (salary plus ex post bonus), one might say that at least bureaucrats don't roll the dice.

The U.S. Congress, of course, does not need to determine root causes in order to respond to a perceived problem of executive pay. After each of the two major stock market meltdowns of the past decade, Congress enacted significant reforms in the area of executive compensation. In 2002, Congress passed the Sarbanes-Oxley Act, which among other things responded to several instances from the early 2000s in which top executives reaped large performance-based payments, only later to disclose that the accounting statements that the market had responded to, where false or misleading. One might think that if the performance had been a mirage, as it turned out, that they should return the money. Section 304 of the Act provides that if a company must restate its financials as a result of executive misconduct, the CEO and CFO must pay back to the company any bonuses, other incentive-based or equity-based pay, and/or trading profits realized in the twelve months after the incorrect financial information was publicly disclosed. In 2010, §954 of the Dodd-Frank Wall Street Reform and Consumer Protection Act added a more stringent clawback requirement. Publicly listed companies that restate their financial statements due to material noncompliance with GAAP reporting requirements must seek repayment from any current or former executive officer of any incentive-based compensation (including stock options) paid during the three-year period prior to the restatement date.

The clawback provisions in Dodd-Frank cover all publicly traded companies. They go beyond the provisions in the Sarbanes-Oxley Act in three important ways. First, the look-back period is extended from twelve months to three years. Second, clawback coverage is extended from the CEO and CFO to any current or former executive. Third, the Act's provision eliminates the requirement of misconduct to trigger clawbacks. Under the new provision, incentive-based compensation can be recovered in the event of accounting restatements due to a company's material noncompliance with financial reporting requirements, regardless of whether the restatements resulted from executive misconduct. In July 2015, about five years after the passage of Dodd-Frank, the SEC finally issued proposed rules implementing these features of the Act's clawback rules. The proposed rules contemplate requiring the stock exchanges to mandate these standards for all listed companies.

The Dodd-Frank Act also initiated a "Say On Pay" shareholder vote. That is, it requires a shareholder advisory vote at least once every three years to approve or reject the compensation of public companies' named executive officers.[9] In addition, the Act requires a non-binding advisory vote to determine whether Say on Pay votes should occur every one, two, or three years. This requirement mirrors the rule that has governed British companies since 2002. Sweden and Australia have also followed the U.K. advisory-vote approach, while the Netherlands, Switzerland, and Norway have gone further on Say on Pay, providing shareholders with a *binding* annual vote on top executive compensation.[10] By the close of the 2014 proxy season, the pattern on these votes had been established. Shareholders generally approve the com-

9. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §951, 124 Stat. 1376, 1899 (2010).

10. Steven Davis, Does "Say on Pay" Work? Lessons on Making CEO Compensation Accountable, 1622 PLI/Corp 33, 46 (2007).

pensation practices of the firms in which they are invested. Of the 3,422 companies that held Say on Pay votes in 2014, only 1.9 percent (sixty-six firms) failed to gain majority approval. Most firms (71 percent) received greater than 90 percent approval in that vote. Larger public companies tended to do a bit better than smaller ones on these votes. These votes are taken with extreme seriousness by corporate management. It has been noted that a failed Say on Pay vote makes it statistically ten times more likely that the next equity pay plan put to the shareholders will also fail. Despite the appearance of general acceptance by shareholders of pay practices, these votes have changed corporate governance practice and have been useful in focusing compensation committees on the fact that their work will be subject to investor scrutiny. Section 954 of the Dodd-Frank Act regulates "golden parachute" compensation through related disclosure and shareholder approval provisions. Any solicitation of shareholder votes to approve an acquisition, merger, consolidation, or proposed sale of all or substantially all of a public company's assets requires the disclosure of any executive compensation arrangements, including the aggregate amount of potential payments, related to the M&A transaction. Moreover, the Act requires a non-binding shareholder advisory vote in connection with the approval of such compensation arrangements.

A "Yes" in Say on Pay
Wall Street Journal (July 8, 2011)

Congress gave shareholders a new "say on pay" over executive compensation. And the returns are in: At 98.5% of companies, the answer was yes.

Of 2532 companies reporting, shareholders at 39 of them rejected executive pay plans. . . . The votes, which were put into place by the Dodd-Frank financial overhaul, are non-binding, so companies don't have to change anything even if shareholders disapprove. H-P and Stanley Black & Decker [two companies that lost Say on Pay votes] declined to comment. . . .

[Despite their non-binding nature], pay watchers say the votes have had an impact. Some companies secured passage by modifying their pay plans at the last minute; others had to lobby hard against criticism.

Shareholders have seized on failed votes as ammunition for lawsuits. They sued boards of directors at a handful of companies whose votes failed, including Jacobs Engineering Group Inc. and Umpqua Holdings Corp.

The suits generally cite the vote rejection as evidence that directors ignored shareholders' wishes for more modest pay packages, breaching their fiduciary duty to investors. [These suits have almost uniformly been dismissed at the motion to dismiss stage — Eds.] . . .

Finally, respecting federal statutes on executive compensation, §953 of the Dodd-Frank Act directs the SEC to adopt executive compensation disclosure rules that require public companies to include the relationship between executives' compensation and company performance in annual proxy statements. In addition, companies are required to disclose the median employee annual compensation, the CEO's annual compensation, and the ratio of these figures. Only in April 2015 did the SEC propose rules that aim to give investors greater clarity about the link between what corporate executives are paid each year compared to total shareholder return — the annual change in stock price plus reinvested dividends. As finalized in August 2015, companies must include in their filings a new table in their annual proxy filings disclosing top executives' "actual pay." That is, a new figure based on the total compensation companies already calculate for their five highest-paid executives, though it would exclude certain components of compensation that officers don't actually take home, such as share grants that have yet to vest.

In August 2015, the SEC also adopted new regulations requiring disclosure of the ratio between CEO pay (somehow calculated) and that of the median worker. This was a directive of Congress. In an editorial on the day after the new regulation was adopted, the *Wall Street Journal* asked whether any investor sensibly needed this disclosure. This question begs a further question: Do you think all of this disclosure is likely to have an (intended) impact on the level or rate of change in CEO pay? If not, is there some other good reason to bear the costs?

9.3 Are CEOS Paid Too Much?

Among the less scintillating topics of dinner table conversations, political barnstorming speeches or newspaper editorials is the topic whether CEOs are paid too much. It of course is not a scientific question. It is one that we or you may have a view about, but we are unlikely to prove to someone holding a different view that they are wrong. Moreover, it seems to be a topic that generates warm emotions. But why does CEO pay have this effect — and not, for example, the pay of top earning athletes, recording artists, movie stars, hedge fund managers (the real mega-buck kings), or Kim Kardashian? They all earn far more than the median CEO of an S&P 500 firm.

During the 2007-2010 financial crisis, the average pay for the chief executive of an American publicly traded company fell from $15.1 million in 2007 to $10.1 million in 2009. Because of the stock market rebound, median CEO pay was up to nearly $12 million in 2010 according to research firm GovernanceMetrics. Throughout this period and increasingly in recent years, the level of CEO pay has raised questions of whether that pay is an efficient arrangement or rather constitutes excess authorized by boards failing, for some reason, to perform correctly.

It should be unsurprising that in a competitive market for talent, CEOs of huge firms are paid a lot. Large firms compete in markets filled with other firms seeking to gain market share and profits. In this competition, many factors affect the performance of any one firm. Some of these factors are controllable to a greater or lesser extent, and others are not. Large teams of organized individuals direct the activities of such firms. No single controllable factor is more important in that competition than the skill, energy, and leadership of the firm's CEO. CEOs of large firms, responsible for the day-to-day deployment and control of billions of dollars in assets, are paid well. As a class, are they paid too well?

One problem with CEO pay is that whatever value she may add is largely invisible to outsiders, unlike performers whose ticket sales can easily be checked. But the fact is that public-company CEO's wield enormous levers, and, if they actually have skill that adds value, that value can benefit shareholders, and even society, enormously. If the company is large, a one percent improvement in corporate value over the next best person can be just as large as, if not greater than, the value created by even the most talented superstar celebrity.

The reason, then, that executive pay receives this attention, in our view, is not the magnitude of the compensation received, but rather the fact that neither the CEO's contribution nor the process by which it is set is transparent to investors (or politicians or journalists). The earnings of celebrities are negotiated at arm's length with sophisticated counterparties. But the process that sets CEO pay is not so clearly the same sort of bargaining process. Because most CEOs sit on their company's board of directors, setting their compensation is subject to the sorts of risks present in related party transactions. Of course, boards establish mechanisms to try to emulate an arm's length negotiation; for example, the compensation committee of the board, consisting entirely of independent directors, typically sets the CEO's pay. But even with these devices, the effort for a truly arm's-length negotiation is tempered by the soft ties that inevitably influence (and in many instances, help) the functioning of collegial bodies such as the board of directors. In addition to board-level soft ties, there are other practical realities. Suspicion may also be raised by the observation that CEO pay often does not appear to closely track measures of corporate performance, such as shareholder returns. That is, it is less variable than corporate performance (but then all worker compensation is steadier than stock market returns[11]).

Of course, any perceived weak correlation between CEO pay and corporate performance might be related to a problem of board capture — that is, board domination by the CEO. Even ostensibly independent compensation committees might be unwilling to inflict a punishing "stick" on their CEO for poor comparative corporate performance, for fear of damaging useful relationships with her. This is a popular academic theme. The short selection by Professor Begnt Holmstrom below offers another, more benign view. Of course, CEOs are usually highly talented managers and, while powerful, they don't control all of the features of the business environment; when exerting observed effort in a board-approved strategy, poor performance in any one year may be temporary and due to bad luck, not insufficient talent or diligence, and thus not deserving of punishing discipline. Firms are not exactly like markets; they are places in which relational contracting occurs. Boards

11. The reason this is so may be that owners of capital have available to them methods to cheaply diversify the risks embedded in any specific investment, while labor — whether executives or shop-floor employees — cannot do so easily or inexpensively.

and (less so) those outside the firm can never know the counter-factual of what performance would have been achieved with the next best CEO.

Scholars have warm views on the topic of CEO pay. On one hand, Professors Lucian Bebchuk and Yaniv Grinstein, leading representatives of the "agency cost" theory of executive pay, calculate that share price performance, industry effects, and increases in firm size can explain only half of the overall growth in CEO pay during the period of 1993 to 2003.[12] Bebchuk and Grinstein further report that aggregate compensation for the top five managers increased from 5 percent of corporate profits in 1993 to approximately 10 percent in 2003.[13] In a similar vein, Professor Kevin J. Murphy calculates that the average pay of a CEO in a public company in 1970 was approximately twenty-five times greater than the average worker's pay, but by 1996, that ratio had increased to over 200 times![14] Another more recent study finds that during the short hot stock market of 2003-2007, CEO pay in the United States grew in real terms by 45 percent compared to a real pay increase of 15 percent in the case of the average executive, and 2.7 percent for the average American worker.[15]

There is academic research that takes another view. For example, Professors Xavier Gabaix and Augustin Landier of NYU's Stern School of Business developed a model of CEO pay that assumed only that there is such a thing as managerial talent, which is rare, that the market for it is competitive, and, most importantly, that this talent produces value as a function of the value of the assets it has power to direct. Thus a talented manager can produce more value if he has $10 billion in assets to manage than if he has $1 billion in assets to manage. This simple model predicted that CEO pay should increase one-to-one with the average market capitalization of large firms in the economy.[16] When their models' predictions are plotted next to actual data, Gabaix and Landier find that the roughly six-fold increase in market capitalization of large U.S. companies between 1980 and 2003 can fully explain the roughly six-fold increase in CEO pay during the same period. So for them there is no general problem of excessive CEO pay — just the market for talent working to distribute the rare resource.

Whatever the explanation for the growth of CEO pay, it is clear that the very large payments made to certain CEOs by their companies are a source of concern to some. Shareholder advocates attack many common features of top executive compensation, including its overall level (for being too high), its form (for not sufficiently punishing failure), the procedures used for setting compensation (for being insufficiently disinterested), and the common

12. Lucian Bebchuk & Yaniv Grinstein, *The Growth of Executive Pay*, 21 Oxford Rev. Econ. Pol'y 283 (2005).

13. Id.

14. Kevin J. Murphy, *Executive Compensation*, in Handbook of Labor Economics [1st pg. of excerpt] (Orley Ashenfelter & David Card eds., 1999).

15. Franz Christian Ebert, Raymond Torres & Konstantinos Papadakis, Executive Compensation: Trends and Policy Issues (2008), http://www.ilo.org/public/english/bureau/inst/publications/discussion/dp19008.pdf.

16. Xavier Gabaix & Augustin Landier, *Why Has CEO Pay Increased So Much?*, 123 Q.J. Econ. 49 (2008).

sweeteners in compensation contracts, such as "golden parachutes," that reward executives for standing aside gracefully in the sale of their companies.

It is difficult to reach a scientific judgment about these issues, partly because it is difficult to estimate the market price for unique executive talent. Senior officers are not fungible. Many suspect that the process that sets their compensation does not produce a true reading of the market, but suspicion is a frail basis for judicial review. Moreover, the recent period of high growth in CEO compensation has also been a time of substantially greater CEO turnover, much of it forced.[17] CEOs get fired more often today than before. This fact is not fully consistent with the board capture theory of compensation. Moreover, economic theory suggests that increases in the riskiness of future payments will reduce the present value of the flow of funds. Thus, we would expect CEO compensation to rise in response to reduced job security as well.

So, are CEOs paid too much? Whichever side of that debate one takes, two things remain clear. First, there are some cases of abusive CEO pay. Second, the general level of CEO pay is such that even if it is in fact efficient, it may can create some level of social costs in the form of resentment, jealousy, and anger. In an age of global competition, shop floor wages in the U.S. are depressed by low-cost manufacturing options offered in developing regions of the world. This constraint is arguably less pertinent in the case of the more rare talent to manage large organizations. So a growing divide between the top and the average workers, even if one may understand its drivers, creates political challenges for corporate boards.

LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: OVERVIEW OF THE ISSUES

30 J. Corp. L. 647 (2005)

. . . Financial economists studying executive compensation have typically assumed that pay arrangements are produced by arm's-length contracting, contracting between executives attempting to get the best possible deal for themselves, and boards trying to get the best possible deal for shareholders. This assumption has also been the basis for the corporate law rules governing the subject. We aim to show, however, that the pay-setting process in U.S. public companies has strayed far from the arm's-length model.

Our analysis indicates that managerial power has played a key role in shaping executive pay. The pervasive role of managerial power can explain much of the contemporary landscape of executive compensation, including practices and patterns that have long puzzled financial economists. We

17. See Steven N. Kaplan & Bernadette A. Minton, *How Has CEO Turnover Changed?*, 12 Int'l Rev. Fin. 57 (Mar. 2012).

also show that managerial influence over the design of pay arrangements has produced considerable distortions in these arrangements, resulting in costs to investors and the economy. This influence has led to compensation schemes that weaken managers' incentives to increase firm value and even create incentives to take actions that reduce long-term firm value. . . .

Many take the view that concerns about executive compensation have been exaggerated. Some maintain that flawed compensation arrangements have been limited to a relatively small number of firms, and that most boards have carried out effectively their role of setting executive pay. Others concede that flaws in compensation arrangements have been widespread, but maintain that these flaws have resulted from honest mistakes and misperceptions on the part of boards seeking to serve shareholders. According to this view, now that the problems have been recognized, corporate boards can be expected to fix them on their own. Still others argue that even though regulatory intervention was necessary, recent reforms that strengthen director independence will fully address past problems; once these reforms are implemented, boards can be expected to adopt shareholder-serving pay policies.

Our work seeks to persuade readers that such complacency is unwarranted. To begin with, flawed compensation arrangements have not been limited to a small number of "bad apples"; they have been widespread, persistent, and systemic. Furthermore, the problems have not resulted from temporary mistakes or lapses of judgment that boards can be expected to correct on their own. Rather they have stemmed from structural defects in the underlying governance structure that enable executives to exert considerable influence over their boards. The absence of effective arm's-length dealing under today's system of corporate governance has been the primary source of problematic compensation arrangements. Finally, while recent reforms that seek to increase board independence will likely improve matters, they will not be sufficient to make boards adequately accountable. Much more needs to be done. . . .

Before proceeding, we want to emphasize that our critique of existing pay arrangements and pay-setting processes does not imply that most directors and executives have acted less ethically than others would have in their place. Our problem is not with the moral caliber of directors and executives, but rather with the system of arrangements and incentives within which directors and executives operate. As currently structured, our corporate governance system unavoidably creates incentives and psychological and social forces that distort pay choices. Such incentives and forces can be expected to lead most people serving as directors to go along with arrangements that favor their firms' executives, as long as these arrangements are consistent with prevailing practices and conventions and thus not difficult to justify to themselves and to others. If we were to maintain the basic structure of the system and merely replace current directors and executives with a different set of individuals, the new directors and executives would be exposed to the very same incentives and forces as their predecessors and, by and large, we would not expect them to act any differently. To address the flaws in the pay-setting process, we need to change the governance arrangements that produce these distortions. . . .

BENGT HOLMSTROM, PAY WITHOUT PERFORMANCE AND THE MANAGERIAL POWER HYPOTHESIS: A COMMENT

30 J. Corp. L. 503 (2005)

. . . Let me start with one anecdotal piece of evidence that explains why I think [Bebchuk & Fried's] basic premise that boards should deal with the executives at arm's-length is rather misguided. I have been on the board of my wife's family business for sixteen years. It is a closely held, global company headquartered in Finland with about 3000 employees and one billion dollars in revenue. There is an outside CEO, but the family controls the board and owns over ninety-five percent of the equity. The chairman of the board, my brother-in-law, is the former CEO. I think it is safe to say that the company does not face the sorts of agency problems that Bebchuk and Fried consider crucial. Yet many of the compensation patterns that the book attributes to a toxic combination of CEO power and wimpy boards can also be found in this reasonably successful family firm.

To determine a CEO's compensation, we consider several factors. We call in a compensation consultant. We look at compensation levels in companies of comparable size. We look at the CEO's mix of bonus and salary. We ask the compensation consultants what they think is appropriate. We ask the CEO what he expects to be paid and how. We are concerned about incentive effects, but in the end we closely follow common practice. The CEO has options as well as a bonus plan, with the bonus tied to strategic goals. Currently, we pay him in the top quartile, because we think it is important that he feels appreciated. When all is said and done, it looks pretty much boilerplate.

Why are we this unimaginative? After thirty years of studying compensation and incentives, do I not have better ideas?

My answer comes in three parts. First, and most importantly, we want to avoid arm's-length bargaining. Compensation is a sensitive matter. We benchmark to remove potentially contentious negotiations from the agenda. If we err, we would rather err a bit on the generous side. Second, we have tried to be more creative about structure, including the use of relative performance evaluation. But the executives did not like the use of relative performance evaluation much and in the end we felt that it would cost us more than it was worth to force acceptance. Third, years of experience with incentive design has made me cautious about experimenting too much. The law of unintended consequences never fails to surprise (we have certainly made our share of mistakes), and when it does it can cause a lot of frustration. Following norms and relying on outside expertise is not so bad after all — let the others be guinea pigs.

One data point does not prove a broader thesis, of course, but I would be rather surprised if my experience differed much from the experience of most family boards. I feel fairly confident in saying that CEO pay is very unlikely to be determined by arm's-length bargaining in most companies, whether they are publicly traded or closely held. But that does not mean that a board should go along with whatever the CEO demands. Benchmarking and staying within norms provide a good defense against overly aggressive demands. The biggest pay excesses have occurred in firms that have used unusual structures (the use of mega-grants is illustrative) and that have not benchmarked properly (Oracle, Siebel Systems and Apple are three examples). For this reason, it is surprising that the Conference Board's recent expert panel on executive compensation recommends that boards should avoid benchmarking and use their own judgment in its place. I know of no economic price which individuals can reliably determine by looking at intrinsic value without regard to the price of comparable products or services. Why should executive markets be any different? . . .

9.4 Judicial Review of Compensation

9.4.1 The Law Executive Officer Compensation

Some might think that judicial review would act as an important constraint on executive compensation, perhaps as a backstop when other mechanisms fail — it is not. Unless actual corruption in the process of awarding compensation can be shown. Delaware courts, if asked to review executive compensation, will defer to the business judgment of the board of directors by deploying the "waste" standard of judicial review. Although specific definitions vary, perhaps the best articulation in this context was set forth in *Gotlieb v. Hayden Chemical Corporation* in 1952. A wasteful transaction is one "that no person of ordinarily sound business judgment would be expected to entertain the view that the consideration furnished. . . . is a fair exchange."[18]

The Delaware judicial approach reflects both the enormous difficulty in assessing executive pay from outside the boardroom, and the courts' traditional respect for the decisions of non-conflicted corporate directors. One might have expected that this approach to the review of compensation decisions would be tested by the compensation practices at large financial institutions during the financial crisis. Newspapers were filled with accounts of top professionals getting paid astronomical sums, while taxpayers funded bailouts of their banks. Famed investment banking house Goldman Sachs was a special object of this critical review, (see sidebar), and plaintiff-shareholders did challenge Goldman's pay practices in Delaware Chancery Court. The opinion, excerpted below, fairly illustrates the unwillingness of the Delaware courts to bend to what may be thought to be the popular sentiment on executive pay.

18. 90 A.2d 660 (Del 1952).

Bonuses Put Goldman in a Public Relations Bind
New York Times *(Oct. 16, 2009)*

A celebrated Goldman Sachs partner, Gus Levy, coined the maxim that long defined the bank, the savviest and most influential firm on Wall Street: "Greedy, but long-term greedy."

But these days that old dictum is being truncated to just "greedy" by some Goldman critics. While many ordinary Americans are still waiting for an economic recovery, Goldman and its employees are enjoying one of the richest periods in the bank's 140-year history.

Goldman executives are perplexed by the resentment directed at their bank and contend the criticism is unjustified. But they find themselves in the uncomfortable position of defending Goldman's blowout profits and the outsize paydays that are the hallmark of its success.

For Goldman employees, it is almost as if the financial crisis never happened. Only months after paying back billions of taxpayer dollars, Goldman Sachs is on pace to pay annual bonuses that will rival the record payouts that it made in 2007, at the height of the bubble. In the last nine months, the bank set aside about $16.7 billion for compensation — on track to pay each of its 31,700 employees close to $700,000 this year. Top producers are expecting multimillion-dollar paydays. . . .

[T]he bank has come to symbolize for many a return to wanton Wall Street excess. Even in 2008, the most tumultuous year in modern Wall Street history, Goldman employees reaped rewards that most people can only dream about. Goldman paid out $4.82 billion in bonuses last year, awarding 953 employees at least $1 million each and 78 executives $5 million or more. The rewards for 2009 will be far greater.

Goldman executives know they have a public opinion problem, and they are trying to figure out what to do about it — as long as it does not involve actually cutting pay. . . .

Despite the news of Goldman's strong quarter, David A. Viniar, the chief financial officer, was on the defensive Thursday. Talk of bonuses, and whether they were justified, dominated what in another era might have been a celebratory call with the media.

"We are very focused on what is going on in the world," Mr. Viniar replied to a barrage of questions about whether the bank should pay outsize bonuses in these hard economic times. "We are focused on the economic climate. We are focused on what is going on with other people."

But he said Goldman had a duty to its employees and to retain staff. By paying big bonuses, he said, the bank was trying to make a difficult trade-off between "being fair to our people who have done a remarkable job" and "what's going on in the world."

Goldman, Mr. Viniar said, was being unfairly singled out over its bonus culture. "Yes, I think that is too big a focus," he said. "I would prefer people to be focused on the success of our business, how well we're doing, and how well our people are performing."

Still, some outsiders wonder if Goldman, which is so adept at reading the markets, is misreading public opinion, and whether the gilded Goldman name will be tarnished by this episode. . . .

IN RE THE GOLDMAN SACHS GROUP, INC. SHAREHOLDER LITIGATION

2011 WL 4826104 (Del. Ch. Oct. 2011)

Glasscock, V.C.

C. Compensation

[Opinion on Defendant's Motion to Dismiss the Complaint –Eds.] Goldman employed a "pay for performance" philosophy linking the total compensation of its employees to the company's performance. Goldman has used a Compensation Committee since at least 2006 to oversee the development and implementation of its compensation scheme. The Compensation Committee was responsible for reviewing and approving the Goldman executives' annual compensation. To fulfill their charge, the Compensation Committee consulted with senior management about management's projections of net revenues and the proper ratio of compensation and benefits expenses to net revenues (the "compensation ratio"). Additionally, the Compensation Committee compared Goldman's compensation ratio to that of Goldman's competitors such as Bear Stearns, Lehman Brothers, Merrill Lynch, and Morgan Stanley. The Compensation Committee would then approve a ratio and structure that Goldman would use to govern Goldman's compensation to its employees.

The Plaintiffs allege that from 2007 through 2009, the Director Defendants approved a management-proposed compensation structure that caused management's interests to diverge from those of the stockholders. According to the Plaintiffs, in each year since 2006 the Compensation Committee approved the management-determined compensation ratio, which governed "the total amount of funds available to compensate all employees including senior executives," without any analysis.[17] Although the total compensation paid by Goldman varied significantly each year, total compensation as a percentage of net revenue remained relatively constant. Because management was awarded a relatively constant percentage of total revenue, management could maximize their compensation by increasing Goldman's total net revenue and total stockholder equity. The Plaintiffs contend that this compensation structure led management to pursue a highly risky business strategy that emphasized short term profits in order to increase their yearly bonuses.

17. Compl. ¶¶90-91. Goldman's total net revenue was $46 billion in 2007, $22.2 billion in 2008, and $45.2 billion in 2009. Compl. ¶115. Goldman paid its employees total compensation of $20.2 billion in 2007, $10.9 billion in 2008, and $16.2 billion in 2009. Compl. ¶116. As a percentage of total net revenue, the total compensation paid by Goldman was 44% in 2007, 48% in 2008, and 36% in 2009. Compl. ¶115. The total compensation initially approved in 2007, by the Compensation Committee, was $16.7 billion or 47% of total revenue; however, this amount was changed after public outcry. Compl. ¶113.

D. Business Risk

The Plaintiffs allege that management achieved Goldman's growth "through extreme leverage and significant uncontrolled exposure to risky loans and credit risks." The trading and principal investment segment is the largest contributor to Goldman's total revenues; it is also the segment to which Goldman commits the largest amount of capital. The Plaintiffs argue that this was a risky use of Goldman's assets, pointing out that Goldman's Value at Risk (VAR) increased between 2007 and 2009, and that in 2007 Goldman had a leverage ratio of 25 to 1, exceeding that of its peers.

The Plaintiffs charge that this business strategy was not in the best interest of the stockholders, in part, because the stockholders did not benefit to the same degree that management did. Stockholders received roughly 2% of the revenue generated in the form of dividends — but if the investment went south, it was the stockholders' equity at risk, not that of the traders.

The Plaintiffs point to Goldman's performance in 2008 as evidence of these alleged diverging interests. In that year, "the Trading and Principal Investment segment produced $9.06 billion in net revenue, but as a result of discretionary bonuses paid to employees lost more than $2.7 billion." This contributed to Goldman's 2008 net income falling by $9.3 billion. The Plaintiffs contend that, but for a cash infusion from Warren Buffett, federal government intervention and Goldman's conversion into a bank holding company, Goldman would have gone into bankruptcy.

The Plaintiffs acknowledge that during this time Goldman had an Audit Committee in charge of overseeing risk. The Audit Committee's purpose was to assist the board in overseeing "the Company's management of market, credit, liquidity, and other financial and operational risks." The Audit Committee was also required to review, along with management, the financial information that was provided to analysts and ratings agencies and to discuss "management's assessment of the Company's market, credit, liquidity and other financial and operational risks, and the guidelines, policies and processes for managing such risks."

* * *

In December 2006, Goldman's CFO, in a meeting with Goldman's mortgage traders and risk managers, concluded that the firm was over-exposed to the subprime mortgage market and decided to reduce Goldman's overall exposure. In 2007, as the housing market began to decline, a committee of senior executives, including Viniar, Cohn, and Blankfein, took an active role in monitoring and overseeing the mortgage unit. The committee's job was to examine mortgage products and transactions while protecting Goldman against risky deals. The committee eventually decided to take positions that would allow Goldman to profit if housing prices declined. When the subprime mortgage markets collapsed, not only were Goldman's long positions hedged, Goldman actually profited more from its short positions than it lost from its long positions. The Plaintiffs allege that Goldman's profits resulted from positions that conflicted with its clients' interests to the detriment of the company's reputation. . . .

III. ANALYSIS

A. Approval of the Compensation Scheme

The Plaintiffs challenge the Goldman board's approval of the company's compensation scheme on three grounds. They allege (1) that the majority of the board was interested or lacked independence when it approved the compensation scheme, (2) the board did not otherwise validly exercise its business judgment, and (3) the board's approval of the compensation scheme constituted waste.

[The court rejected as insufficiently particularized plaintiffs' allegations that various donations by the Goldman Sachs Foundation to institutions upon whose boards various Goldman directors served were sufficient to render such directors non-independent of the Goldman insiders, who qualified for the incentive compensation payments being challenged.]

B. Otherwise the Product of a Valid Exercise of Business Judgment

. . . The Plaintiffs assert that the Director Defendants owed "a fiduciary duty to assess continually Goldman's compensation scheme to ensure that it reasonably compensated employees and reasonably allocated the profit of Goldman's activities according to the contributions of shareholder capital and the employees of the Company." The Plaintiffs contend that the entire compensation structure put in place by the Director Defendants was done in bad faith and that the Director Defendants were not properly informed when making compensation awards. I find that the Plaintiffs have not provided particularized factual allegations that raise a reasonable doubt whether the process by which Goldman's compensation scheme allocated profits between the employees and shareholders was implemented in good faith and on an informed basis.

1. *Good Faith*

. . . The Plaintiffs' main contention is that Goldman's compensation scheme itself was approved in bad faith. The Plaintiffs allege that "[n]o person acting in good faith on behalf of Goldman consistently could approve the payment of between 44% and 48% of net revenues to Goldman's employees year in and year out" and that accordingly the Director Defendants abdicated their duties by engaging in these "practices that overcompensate management." The complaint is entirely silent with respect to any individual salary or bonus; the Plaintiffs' allegation is that the scheme so misaligns incentives that it cannot have been the product of a good faith board decision.

The Plaintiffs' problems with the compensation plan structure can be summarized as follows: Goldman's compensation plan is a positive feedback loop where employees reap the benefits but the stockholders bear the losses. Goldman's plan incentivizes employees to leverage Goldman's assets and engage in risky behavior in order to maximize yearly net revenue and their yearly bonuses. At the end of the year, the remaining revenue that is not paid as compensation, with the exception of small dividend payments to stockholders, is funneled back into the company. This increases the quantity of assets Goldman employees have available to leverage and invest. Goldman employees then start the process over with a greater asset base, increase net revenue again, receive even larger paychecks the next year, and the cycle continues. At the same time, stockholders are only receiving a small percentage of net revenue as dividends; therefore, the majority of the stockholders' assets are simply being cycled back into Goldman for the Goldman employees to use. The stockholders' and Goldman employees' interests diverge most notably, argue the Plaintiffs, when there is a drop in revenue. If net revenues fall, the stockholders lose their equity, but the Goldman employees do not share this loss.[138]

The decision as to how much compensation is appropriate to retain and incentivize employees, both individually and in the aggregate, is a core function of a board of directors exercising its business judgment. The Plaintiffs' pleadings fall short of creating a reasonable doubt that the Directors Defendants have failed to exercise that judgment here. The Plaintiffs acknowledge that the compensation plan authorized by Goldman's board, which links compensation to revenue produced, was intended to align employee interests with those of the stockholders and incentivize the production of wealth. To an extent, it does so: extra effort by employees to raise corporate revenue, if successful, is rewarded. The Plaintiffs' allegations mainly propose that the com pensation scheme implemented by the board does not perfectly align these interests; and that, in fact, it may encourage employee behavior incongruent with the stockholders' interest. This may be correct, but it is irrelevant. The fact that the Plaintiffs may desire a different compensation scheme does not indicate that equitable relief is warranted. Such changes may be accomplished through directorial elections, but not, absent a showing unmet here, through this Court.

Allocating compensation as a percentage of net revenues does not make it virtually inevitable that management will work against the interests of the stockholders. Here, management was only taking a percentage of the net revenues. The remainder of the net revenues was funneled back into the company in order to create future revenues; therefore, management and stockholder interests were aligned. Management would increase its compensation by increasing revenues, and stockholders would own a part of a company which has more assets available to create future wealth.

The Plaintiffs' focus on percentages ignores the reality that over the past 10 years, in absolute terms, Goldman's net revenue and dividends have substantially increased. Management's compensation is based on net revenues. Management's ability to generate that revenue is a function of the total asset base, which means management has an interest in maintaining that base (owned, of course, by the Plaintiffs and fellow shareholders) in order to create future revenues upon which its future earnings rely.

138. In actuality, of course, a drop in revenue does have a direct negative impact on employees, because their income is tied to revenue.

. . . The Plaintiffs do not allege that the board failed to employ a metric to set compensation levels; rather, they merely argue that a different metric, such as comparing Goldman's compensation to that of hedge fund managers rather than to compensation at other investment banks, would have yielded a better result. But this observance does not make the board's decision self-evidently wrong, and it does not raise a reasonable doubt that the board approved Goldman's compensation structure in good faith.

2. *Adequately Informed*

The Plaintiffs also contend that the board was uninformed in making its compensation decision. "Pre-suit demand will be excused in a derivative suit only if the . . . particularized facts in the complaint create a reasonable doubt that the informational component of the directors' decisionmaking process, measured by concepts of gross negligence, included consideration of all material information reasonably available." Here, Goldman's charter has a 8 Del. C. §102(b)(7) provision, so gross negligence, by itself, is insufficient basis upon which to impose liability. The Plaintiffs must allege particularized facts creating a reasonable doubt that the directors acted in good faith.

The Plaintiffs allege that the Director Defendants fell short of this reasonableness standard in several ways. They point out that the Director Defendants never "analyzed or assessed the extent to which management performance, as opposed to the ever-growing shareholder equity and assets available for investment, has contributed to the generation of net revenues." The Plaintiffs also argue that because the amount of stockholder equity and assets available for investment was responsible for the total revenue generated, the Director Defendants should have used other metrics, such as compensation levels at shareholder funds and hedge funds, to decide compensation levels at Goldman. The Plaintiffs allege that Goldman's performance, on a risk adjusted basis, lagged behind hedge fund competitors, yet the percentage of net revenue awarded did not substantially vary, and that the Director Defendants never adequately adjusted compensation in anticipation of resolving future claims.

Nonetheless, the Plaintiffs acknowledge that Goldman has a compensation committee that reviews and approves the annual compensation of Goldman's executives. The Plaintiffs also acknowledge that Goldman has adopted a "pay for performance" philosophy, that Goldman represents as a way to align employee and shareholder interests. The Plaintiffs further acknowledge that Goldman's compensation committee receives information from Goldman's management concerning Goldman's net revenues and the ratio of compensation and benefits expenses to net revenues. Finally, the Plaintiffs note that the compensation committee reviewed information relating to the compensation ratio of Goldman's "core competitors that are investment banks (Bear Stearns, Lehman Brothers, Merrill Lynch, and Morgan Stanley)."

Rather than suggesting that the Director Defendants acted on an uninformed basis, the Plaintiffs' pleadings indicate that the board adequately informed itself before making a decision on compensation. The Director

Defendants considered other investment bank comparables, varied the total percent and the total dollar amount awarded as compensation, and changed the total amount of compensation in response to changing public opinion. None of the Plaintiffs' allegations suggests gross negligence on the part of the Director Defendants, and the conduct described in the Plaintiffs' allegations certainly does not rise to the level of bad faith such that the Director Defendants would lose the protection of an 8 Del. C. §102(b)(7) exculpatory provision.

At most, the Plaintiffs' allegations suggest that there were other metrics not considered by the board that might have produced better results. The business judgment rule, however, only requires the board to reasonably inform itself; it does not require perfection or the consideration of every conceivable alternative. The factual allegations pled by the Plaintiffs, therefore, do not raise a reasonable doubt that the board was informed when it approved Goldman's compensation scheme.

3. Waste

The Plaintiffs also contend that Goldman's compensation levels were unconscionable and constituted waste. To sustain their claim . . . the Plaintiffs must raise a reasonable doubt that Goldman's compensation levels were the product of a valid business judgment. Specifically, to excuse demand on a waste claim, the Plaintiffs must plead particularized allegations that "overcome the general presumption of good faith by showing that the board's decision was so egregious or irrational that it could not have been based on a valid assessment of the corporation's best interests."[152]

"[W]aste entails an exchange of corporate assets for consideration so disproportionately small as to lie beyond the range at which any reasonable person might be willing to trade."[153] Accordingly, if "there is any substantial consideration received by the corporation, and if there is a good faith judgment that in the circumstances the transaction is worthwhile, there should be no finding of waste."[154] The reason being, "[c]ourts are ill-fitted to attempt to weigh the 'adequacy' of consideration under the waste standard or, ex post, to judge appropriate degrees of business risk."[155] Because of this, "[i]t is the essence of business judgment for a board to determine if a particular individual warrant[s] large amounts of money."[156]

The Plaintiffs' waste allegations revolve around three premises: that Goldman's pay per employee is significantly higher than its peers, that Goldman's compensation ratios should be compared to hedge funds and other shareholder funds to reflect Goldman's increasing reliance on proprietary

152. *Citigroup*, 964 A.2d at 136 (quoting *White v. Panic*, 783 A.2d 543, 554 n.36 (Del. 2001)).

153. *Lewis v. Vogelstein*, 699 A.2d 327, 336 (Del. Ch. 1997).

154. Id.

155. Id.

156. *Brehm*, 746 A.2d at 263 (internal quotations omitted).

trading as opposed to traditional investment banking services, and that Goldman's earnings and related compensation are only the result of risk taking.

The Plaintiffs consciously do not identify a particular individual or person who received excessive compensation, but instead focus on the average compensation received by each of Goldman's 31,000 employees. The Plaintiffs allege that "Goldman consistently allocated and distributed anywhere from two to six times the amounts that its peers distributed to each employee," and the Plaintiffs provide comparisons of Goldman's average pay per employee to firms such as Morgan Stanley, Bear Stearns, Merrill Lynch, Citigroup, and Bank of America. The Plaintiffs note that these firms are investment banks, but do not provide any indication of why these firms are comparable to Goldman or their respective primary areas of business. The Plaintiffs do not compare trading segment to trading segment or any other similar metric. A broad assertion that Goldman's board devoted more resources to compensation than did other firms, standing alone, is not a particularized factual allegation creating a reasonable doubt that Goldman's compensation levels were the product of a valid business judgment.

The Plaintiffs urge that, in light of Goldman's increasing reliance on proprietary trading, Goldman's employees' compensation should be compared against a hedge fund or other shareholder fund. The Plaintiffs allege that Goldman's compensation scheme is equal to 2% of net assets and 45% of the net income produced, but a typical hedge fund is only awarded 2% of net assets and 20% of the net income produced. The Plaintiffs paradoxically assert that "no hedge fund manager may command compensation for managing assets at the annual rate of 2% of net assets and 45% of net revenues," but then immediately acknowledge that in fact there are hedge funds that have such compensation schemes. It is apparent to me from the allegations of the complaint that while the majority of hedge funds may use a "2 and 20" compensation scheme, this is not the exclusive method used to set such compensation. Even if I were to conclude that a hedge fund or shareholder fund would be an appropriate yardstick with which to measure Goldman's compensation package and "even though the amounts paid to defendants exceeded the industry average," I fail to see a "shocking disparity" between the percentages that would render them "legally excessive."

In the end, while the Goldman employees may not have been doing, in the words of the complaint and Defendant Blankfein, "God's Work," the complaint fails to present facts that demonstrate that the work done by Goldman's 31,000 employees was of such limited value to the corporation that no reasonable person in the directors' position would have approved their levels of compensation. Absent such facts, these decisions are the province of the board of directors rather than the courts. Without examining the payment to a specific individual, or group of individuals, and what was specifically done in exchange for that payment, I am unable to determine whether a transaction is "so one sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration."

The closest the Plaintiffs come to pleading waste with any factual particularity is in regards to the payment to the Trading and Principal Investment segment in 2008. The Plaintiffs allege that in 2008 "the Trading and Principal

Investments segment produced $9.06 billion in net revenue, but, as a result of discretionary bonuses paid to employees, lost more than $2.7 billion for the [stockholders]." The Plaintiffs' allegations, however, are insufficient to raise a reasonable doubt that Goldman's compensation levels in this segment were the product of a valid business judgment. As a strictly pedagogic exercise, imagine a situation where one half of the traders lost money, and the other half made the same amount of money, so that the firm broke even. Even if no bonus was awarded to the half that lost money, a rational manager would still want to award a bonus to the half that did make money in order to keep that talent from leaving. Since net trading gains were $0, these bonuses would cause a net loss, but there would not be a waste of corporate assets because there was adequate consideration for the bonuses. Without specific allegations of unconscionable transactions and details regarding who was paid and for what reasons they were paid, the Plaintiffs fail to adequately plead demand futility on the basis of waste.

Finally, the Plaintiffs herald the fact that during the sub-prime crisis the Director Defendants continued to allocate similar percentages of net revenue as compensation while the firm was engaged in risky transactions; however, "there should be no finding of waste, even if the fact finder would conclude ex post that the transaction was unreasonably risky. Any other rule would deter corporate boards from the optimal rational acceptance of risk."[169] Because this complaint lacks a particular pleading that an individual or group of individuals was engaged in transactions so unconscionable that no rational director could have compensated them, the Plaintiffs have failed to raise a reasonable doubt that the compensation decisions were not the product of a valid business judgment.

[The court also considered and rejected the plaintiffs' claim that the board had breached its duty to monitor as required under *Caremark*.]

IV. CONCLUSION

The Delaware General Corporation law affords directors and officers broad discretion to exercise their business judgment in the fulfillment of their obligations to the corporation. Consequently, Delaware's case law imposes fiduciary duties on directors and officers to ensure their loyalty and care toward the corporation. When an individual breaches these duties, it is the proper function of this Court to step in and enforce those fiduciary obligations.

Here, the Plaintiffs allege that the Director Defendants violated fiduciary duties in setting compensation levels and failing to oversee the risks created thereby. The facts pled in support of these allegations, however, if true, support only a conclusion that the directors made poor business decisions. Through the business judgment rule, Delaware law encourages corporate fiduciaries to attempt to increase stockholder wealth by engaging in those

169. Lewis, 699 A.2d at 336.

risks that, in their business judgment, are in the best interest of the corporation "without the debilitating fear that they will be held personally liable if the company experiences losses."[12] The Plaintiffs have failed to allege facts sufficient to demonstrate that the directors were unable to properly exercise this judgment in deciding whether to bring these claims. . . .

9.5 Judicial Review of Director Compensation

The role of the corporate board in the practical operation of corporate governance of large public companies has been transformed over the past twenty-five years. Today's board is in general more engaged as an active agent in monitoring and directing the major affairs of the firm than was the case in earlier decades. Concomitantly, service on the board of a public company today takes greater commitment in time and effort. One result of these greater demands is a rise in compensation that is paid to directors of large public companies.

In the past, it was somewhat rare to encounter a shareholder's derivative suit against directors claiming their compensation was excessive. This was principally because, with compensation in those days ranging from $75 thousand to $200 thousand, the potential recovery was not such, even were the case otherwise assumed to be strong, as to entice a contingency fee driven attorney to undertake it. Director's pay has been rising, however, and—in the case of tech start-ups—with stock or option-based compensation, director compensation can get quite large.[13] Large enough, anyway, to look appealing to plaintiff attorneys. As a result, corporate lawyers are today required to pay closer attention to how this subject is addressed by boards.

The fundamental difference between compensation of directors as opposed to officers is that director compensation is a self-dealing transaction requiring more careful judicial review. In the case of director compensation, the only available "cleansing" agency is a shareholder ratification vote. It is the universal practice to seek shareholder approval of such grants, typically through the approval by the shareholders of a board adopted incentive plan scheme that will cover officers, directors and sometimes others. Therefore, when director compensation is challenged as a breach of fiduciary duty, the issues inevitably revolve around how specifically the director grants are defined or limited in the plan which shareholder has approved.

12. *Citigroup*, 964 A.2d at 139.

13. One publication list twelve companies that paid stipends between $500,000 and $1,00,000 to each of their directors in 2011, including Amazon and HP, Inc. http://www.foxbusiness.com/business-leaders/2012/06/08/12-companies-with-highest-paid-boards-directors/.