Reforming Executive Compensation

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Given the fact that the federal government had to bring the economy back from the brink of utter collapse less than two years ago, the investing public understandably expected to see significant changes to the compensation paid to executives. Shareholders widely felt that the old system of incentivizing executives to boost short-term profits through reckless trading strategies surely must give way to rewarding only long-term, sustainable growth. Even shareholders who normally shy away from executive pay issues are tired of the "big-money culture" at financial institutions that threatened to bring our entire financial system down.[1] What the public is finding, however, is that nothing has really changed on Wall Street.

Companies are continuing to award huge bonuses – even companies that took billions of dollars in federal bail-out money. For example, AIG is insisting on paying millions in retention bonuses to its employees although the company remains in existence solely because the government gave it $182 billion.[2] Goldman Sachs, which also took billions of dollars in federal bail-out money to stay afloat until it repaid the loan recently, originally intended to pay $23 billion in bonuses, the most in the Company's 140-year history.[3] It yielded, however, to the pressures of a shareholder lawsuit and negative press, ultimately cutting its bonus pool to the smallest amount it has paid since going public in 1999 – 36% of revenue.[4] However, Goldman still paid bonuses of $16.2 billion.[5] Morgan Stanley paid $14.4 billion in compensation, an astounding 62% of its net revenues even though it lost money in 2009.[6] Bank of America, which completed its purchase of troubled Merrill Lynch in January 2009, intends to pay Merrill Lynch bankers the same level of bonuses ($5.6 billion) that they received in 2007 when they nearly destroyed the company.[7]

Reforming executive compensation is imperative to improving shareholder returns. Empirical research shows that where large bonus compensation is tied to performance metrics achieved in the previous year, executives are far less likely to take into account the long-term consequences of their business strategy. The data shows that firms with high executive compensation generally engage in riskier activity. A recent study entitled *Yesterday's Heroes*: *Compensation and Creative Risk-Taking*, found: "Firms with high executive compensation have a higher . . . return volatility, and are more likely to be in the tails of performance, with extremely good performance pre-crisis when the market did well and extremely poor performance during the crisis period when the market did poorly."[8] Similarly, a study by Moody's Investor Service ("Moody's") found that high executive bonuses correlated with greater credit risk.[9]

The heavy emphasis in the current executive compensation structure on immediate and substantial rewards for short-term gain not only leads to excessive risk-taking, but also creates a fertile environment for outright fraud. The Moody's study found that "large incentive-pay packages may lead managers to focus on accounting results, which may, at best, divert management attention from the underlying business or, at worst, create an environment that ultimately leads to fraud."[10]

Shareholder Litigation to Stop Executive Compensation Abuses

The Backdrop of "Wide Latitude" for Executive Compensation Practices

In the past, shareholder litigation to reform executive compensation practices has met with limited success. State corporate law typically gives boards broad discretion to set executive compensation. Indeed, under Delaware law, "a board's decision on executive compensation is entitled to great deference." *In re Tyson Foods, Inc.*, 919 A.2d 563, 588 (Del. Ch. 2007) (internal quotations omitted).

Suits to recover excessive compensation are derivative in nature, meaning that a shareholder brings suit on behalf of the company. Because the board of directors holds the power to decide when the company will bring litigation, a shareholder bringing suit in the company's name must demonstrate that a majority of the board is incapable of making the judgment of whether to sue. To make this showing, a plaintiff must be able to plead particularized facts to show that a majority of the board is either financially interested in the compensation paid or lacks independence from those who are interested in it. *See Brehm v. Eisner*, 746 A.2d 244, 256 (Del. 2000); *Friedman v. Beningson*, 1995 WL 716762, at *4 (Del. Ch. 1995) ("Th[e] inquiry [into director independence] may include the subject whether some or all directors are . . . under the control, domination or strong influence of a party with a material financial interest in the transaction under attack, which interest is adverse to that of the corporation"). Shareholders may also plead "facts [that] show [compensation] amounts, compared with the services to be received in exchange, constitute waste or could not otherwise be the product of a valid exercise of business judgment." *Grimes v. Donald*, 673 A.2d 1207, 1215 (Del. 1996), *overruled on other grounds by Brehm*, 746 A.2d at 256. Both of these showings can be difficult to make.

Even if an excessive compensation claim survives a motion to dismiss, "[such claims] are difficult to prove at trial, largely because executive compensation is a matter ordinarily left to the business judgment of a company's board of directors." *Lewis v. Hirsch*, 1994 WL 263551, at *3 (Del. Ch. 1994). The significant deference the courts typically gave boards in the past in setting executive compensation is demonstrated in the *Disney*/Ovitz case. *In re Walt Disney Co. Deriv. Litig.*, 906 A.2d 27, 35 (Del. 2006). There, the Delaware Court of Chancery found at trial that paying Michael Ovitz, the former president of Disney, a severance package of over $130 million after only 14 months on the job did not constitute waste.

The compensation committee at Disney did not breach its fiduciary duties because, the Court found, it reasonably informed itself of the terms of the employment contract before approving it. *Id*. at 57. The severance payment called for by the contract did not constitute waste because it was not so "one sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration." *Id.* at 74. According to the Court's findings, the severance agreement, entered into when Ovitz joined Disney, had the "rational business purpose" to induce Ovitz to join the company.

The Changing Tide: Recent Cases Display Willingness of Courts to Entertain Challenges to Executive Compensation

Interestingly, the judicial system may well be heeding the public outrage over executive compensation more than boards themselves. Two recent opinions demonstrate a greater willingness of the courts to sustain shareholder challenges to executive compensation.

The first is the *Citigroup* opinion of the Delaware Court of Chancery. *In re Citigroup Inc. S'holder Deriv. Litig.*, 964 A.2d 106 (Del. Ch. 2009). Plaintiffs in that case challenged the extraordinary benefit package awarded to Charles Prince upon his retirement as Citigroup's CEO in November 2007. Prince's retirement package, consisting of bonus, salary, accumulated stockholders, and the provision of an office, an assistant and a car and driver for 5 years, all of which was valued in excess of $68 million. In exchange for this largesse, Prince agreed to "sign a non-compete agreement, a non-disparagement agreement, a non-solicitation agreement, and a release of claims against the Company." *Id.* at 115.

Because the shareholder plaintiffs were proceeding on a waste claim, they had a high bar to clear on a motion to dismiss. The plaintiffs had to show "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." *Id.* at 136. The Court also noted the longstanding policy of the judiciary to give boards of directors broad discretion in fashioning executive compensation.

Even with the law being so favorable to the *Citigroup* board's decision on Prince's retirement package, the Court still upheld the claim on a motion to dismiss. The Court stated that:

> [t]he directors of a Delaware corporation have the authority and broad discretion to make executive compensation decisions . . . It is also well settled in our law, however, that the discretion of directors in setting executive compensation is not unlimited. Indeed, the Delaware Supreme Court was clear when it stated that "there is an outer limit" to the board's discretion to set executive compensation, "at which point a decision of the directors on executive compensation is so disproportionately large as to be unconscionable and constitute waste."

Id. at 138 quoting *Brehm*, 746 A.2d at 263. Because the overall value of the various components of Prince's retirement compensation called into doubt whether the package was so disproportionately large and so one-sided, the Court held that plaintiffs had stated a claim for waste sufficient to withstand a motion to dismiss. *Id.* ("[T]here is a reasonable doubt as to whether the letter agreement [containing the terms of Prince's compensation package] meets the admittedly stringent 'so one sided' standard or whether the letter agreement awarded compensation that is beyond the 'outer limit' described by the Delaware Supreme Court.").

In a dissenting opinion from a U.S. Court of Appeals for the Seventh Circuit decision not to hear *en banc* a case affirming the dismissal of claims alleging an investment advisor's fee was too high, Judge Richard Posner noted the growing discontent of the investing world with executive compensation. *Jones v. Harris Assocs. L.P.*, 537 F.3d 728, 730 (7th Cir. 2008). He stated that the "economic analysis" of executive compensation "is ripe for reexamination on the basis of growing indications that executive compensation in large publicly traded firms often is excessive because of the feeble incentives of boards of directors to police compensation." Judge Posner noted that directors are often CEO's of other companies and are naturally inclined to believe that CEO's should be well paid.

Finally, he observed that boards should not be accorded any greater deference for their use of compensation experts because

> [c]ompensation consulting firms, which provide cover for generous compensation packages voted by boards of directors, have a conflict of interest because they are paid not only for their compensation advice but for other services to the firm-services for which they are hired by the officers whose compensation they advised on.

Id. The Supreme Court has agreed to hear the case. *Jones v. Harris Assocs. L.P.*, 129 S. Ct. 1579 (2009).

The Federal Regulation of Executive Compensation

Limitations on Companies Receiving TARP

Recognizing that state law may not be sufficient to curb executive compensation, the federal government is taking steps to regulate how much corporations pay their employees. With the enactment of the Troubled Asset Relief Program ("TARP") in October 2008, the federal government paid hundreds of billions of dollars to keep afloat failing financial institutions. In exchange for receiving TARP funds, those companies were required to institute a number of curbs on executive compensation. Those limits on executive compensation were strengthened by the stimulus bill that was enacted on Feb. 17, 2009. *See* Public Law 111–5, American Recovery and Reinvestment Act of 2009.

Currently, companies that have received and not paid back TARP funds are subject to the following restrictions and requirements:

- Limits on compensation that incentivizes unnecessary risk

- Clawback of compensation "based on statements of earnings, revenues, gains, or other criteria that are later found to be materially inaccurate"
- Prohibition on golden parachutes paid to senior executive officers and the next five highest paid officers
- Limiting bonuses of certain executives to restricted stock that does not fully vest before TARP funds are returned in an amount not greater than 1/3 annual compensation and any other terms the Treasury Secretary may impose. For companies that received less that $25 million in TARP funds, the limitations only apply to the highest paid executive. For companies that received between $25 and $250 million, the limitations apply to the five highest paid executives and to other executives designated by the Treasury Secretary. For companies that received between $250 and $500 million, the limitations apply to the ten highest paid executives and to other executives designated by the Treasury Secretary. For companies that received over $500 million, the limitations apply to the senior executive officers, the next 20 highest paid persons paid persons and to other executives designated by the Treasury Secretary.
- Prohibition on compensation that encourages manipulation of earnings
- Requirement to have an independent compensation committee
- Requirement of a company-wide policy limiting luxury expenditures
- Requirement to have a non-binding shareholder vote on executive pay (commonly known as "Say on Pay")

Where boards of TARP money recipients have failed to cut executive compensation, the government is taking action. In June of 2009, President Obama appointed Kenneth Feinberg to design specific compensation programs for TARP companies to ensure that companies were complying with TARP's limits on executive compensation. Feinberg, referred to in the financial press as the Pay Czar, moved quickly to address the public outcry over executive compensation at TARP companies. In October 2009, Feinberg limited base salaries of AIG executives to $500,000 unless such executives could show good cause for a higher amount. Some of these executives must have met that showing because all indications are that Feinberg will allow some AIG executives to receive more than $500,000. *See* Hugh Son, *Feinberg Said to Lift $500,000 Cap for AIG Executives*, Bloomberg, Dec. 8, 2009. Feinberg has also requested that former Bank of America CEO Ken Lewis receive no compensation for 2009, his last year at the bank.[11] At Citibank, Feinberg cut 2009 executive compensation across the board by 70% to $272 million.[12]

H.R. 3269

On July 21, 2009, Barney Frank (D-MA) introduced H.R. 3269, which would reform how all companies, not just companies that receive TARP funds, determine executive pay. The bill requires companies to have a non-binding shareholder vote on executive pay. Furthermore, where shareholders are asked to approve a merger, the bill would require a nonbinding vote on the company's golden parachutes. The bill would also require companies to have independent compensation committees. Finally, the bill would require additional disclosures by financial institutions so that regulators can determine whether the company's compensation package "is aligned with sound risk management; is structured to account for the time horizon of risks; . . . and reduce[s] unreasonable incentives offered by such institutions for employees to take undue risks that could threaten the safety and soundness of covered financial institutions; or could have serious adverse effects on economic conditions or financial stability." The Senate version of the bill is currently pending.

Conclusion

The decision of financial companies to pay executives huge bonuses after taxpayers funded a $700 billion bailout caused outrage among the public, shareholders, judges, and lawmakers. As a result, executive compensation practices are coming under closer scrutiny. While boards of directors still have broad authority to set executive compensation, courts are recognizing limitations to this authority. Key policymakers are now realizing that in addition to curbing the overall excessive nature of executive compensation, it is time to reform the system to eliminate the incentives to favor short-term over long-term growth.

Despite this backdrop of increased governmental activity with respect to executive pay, it is important to remember that shareholders can play a meaningful role in regulating the conduct of directors. For example, even without H.R. 3269, shareholders can submit proposals to be included in company's proxy statements pursuant to Rule 14a-8 that would require a Say-on-Pay vote. Companies may be responsive to changing compensation practices if shareholders register strong disapproval of executive pay. For the more egregious abuses, where directors act in bad faith or wholly abdicate their fiduciary duty to set appropriate compensation, shareholders may bring a derivative suit to recover the excessive compensation.

1 *See* Susanne Craig, *Goldman Holders Miffed at Bonuses* Wall St. J., Nov. 23, 2009.

2 *See* Gabriel Sherman, *Show Me the Money*, N.Y. Mag., Nov. 22, 2009.

3 *See* Andrew Sorkin, *Don't Fail, or Reward Success*, N.Y. Times (Oct. 12, 2009). Goldman Sachs not only received federal money directly through the Troubled Asset Relief Program ("TARP"), it also received billions indirectly through payouts on financial contracts it had with AIG —payouts that were themselves funded by AIG's receipt of $182 billion in federal assistance.

4 *See* Gavin Finch and Ambereen Choudhury, *Barclays Capital's 2009 Pay to Exceed Goldman Sachs*, BusinessWeek, Feb. 16, 2010.

5 Steve Eder, *Goldman Could Slash CEO Bonus Amid Pressure,* Reuters (Feb. 1, 2010).

6 Michael Corkery, *Morgan Stanley's Big Fat Bonus Expense*, Deal Journal (Jan. 20, 2010).

7 *See* Dan Fitzpatrick, *For BofA Investment Bankers, Bonuses Likely Close to 2007*, Wall. St. J., Jan. 8, 2010.

8 Ing-Haw Cheng, Harrison Hong, Jose Scheinkman, *Yesterday's Heroes*: *Compensation and Creative Risk-Taking*, Oct. 2009, available at http://www.princeton.edu/~joses/wp/yesterday.pdf.

9 Christopher Mann, *CEO Compensation and Credit Risk*, Moody's Investors Service, July 2005, at 2 ["Moody's Study"]; *see also Observations on Risk Management Practices During the Rent Market Turbulence*, Senior Supervisors Group, Mar. 6, 2008, at 7 (finding that at poor performing financial firms, senior management was incentivized to "generate earnings" without "clear guidance on the tolerance for expanding exposures to risk.").

10 Moody's Study at 2; *see also* Shane A. Johnson, Harley E. Ryan, Jr. & Yisong S. Tian, *Executive Compensation and Corporate Fraud*, July 23, 2003, at 31 (unpublished working paper) (finding that when a chief executive officer receives a large stock option package without long-term vesting requirements, there is a much greater likelihood that the company in question will misrepresent their financial position); Merle Erickson, Michelle Hanlon & Edward Maydew, *Is There a Link Between Executive Compensation and Accounting Fraud?*, Feb. 24, 2004, at 5-6 (working paper) (finding that executives who received a large amount of equity compensation were more likely to engage in fraud).

11 *See* Reuters, *Pay czar Kenneth Feinberg asks Bank of America CEO Ken Lewis to forgo year's pay* (Oct 16, 2009).

12 *See Top Citibank and Bank of America Executives Average $18.2 Million in Compensation Annually*, American Banking News, Oct. 24, 2009. Available at http://www.americanbankingnews.com/2009/10/24/top-citibank-nyse-c-and-bank-of-america-nyse-c-executives-average-18-2-million-in-compensation-annually.

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