

# DEFENSE AND INVESTIGATIONS REPORT

## Delaware Court Reviews Executive Compensation Issues

In these turbulent economic times, issues related to executive compensation make the news almost every day. As many companies and employees struggle, board members face the at times difficult task of deciding compensation for corporate executives. If a board sets the compensation too low, a company could lose talented executives. If a board sets the compensation too high, shareholders might file a derivative suit alleging a "waste" of corporate assets. If a company accepts bailout funds, the government may attempt to influence executive compensation in unprecedented ways. A recent Delaware case suggests that courts may be more willing to intervene than in the past on executive compensation issues.

Should courts be second-guessing a company's decision as to how executives deserve to be compensated? In Delaware, where many companies are incorporated, the courts have been somewhat deferential to boards of directors, and have generally refused to get involved. Courts in Delaware routinely dismiss claims by shareholders attempting to challenge the board's judgment on executive compensation and similar matters. Under a doctrine known as the "business judgment rule," Delaware courts will presume that the board acted on an informed basis, in good faith, and in the best interests of the company. In June 2006, in a derivative action styled as *In re Walt Disney Co.*, the Supreme Court of Delaware upheld a trial court's decision that the Disney board of directors acted in good faith when it authorized a \$140 million severance package to executive Michael Ovitz, despite the fact that Mr. Ovitz had worked at Disney for only about a year. The Court specifically acknowledged that "the actions of the Disney board that gave rise to this lawsuit" took place prior to the "era of Enron and WorldCom debacles[.]" and went on to "strongly encourage" that boards employ "best practices, as those practices are understood at the time[.]"

Corporate governance standards have indeed changed since the Disney board approved the severance package for Mr. Ovitz. Last month, in a derivative action styled as *In re Citigroup Inc. Shareholder Derivative Litig.*, the Delaware Court of Chancery set a limit on when boards of directors will receive automatic protection for their decision-making on compensation issues. In *Citigroup*, the shareholders filed a lawsuit challenging a November 2007 decision by the company's board, which approved a \$68 million payment and benefit package to departing CEO Charles Prince. The

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shareholders further claimed that the decision to compensate Mr. Prince at that level was “one sided” because his “failures as CEO” were responsible, in part, for billions of dollars in losses at Citigroup. The company urged the court to dismiss the claim based on the business judgment rule. The court opined that “the discretion of directors in setting executive compensation is not unlimited[,]” and the “outer limit” is when the compensation reaches a level “so disproportionately large as to be unconscionable[.]” The court went on to hold that it did not yet have sufficient information to determine whether Mr. Prince’s compensation was beyond the “outer limit” and allowed the shareholders’ claim to proceed.

There is little disagreement that excessive compensation is wasteful of corporate assets, but how are board members to determine what is excessive or beyond the outer limit? Existing decisions from courts in Delaware and elsewhere offer some guidance, but the current economic climate suggests that new factors may become relevant. Earlier this month, for example, the U.S. House of Representatives approved a bill linking executive pay to performance for companies receiving TARP Funds, and giving the Attorney General the authority to subpoena those involved in the compensation process. The SEC’s Enforcement Division may also begin to show more focus on executive compensation issues.

Recent headlines likewise signal a scaling-back or “pay for performance” attitude not present in years past. Last month, for example, Bank of America Corporation reportedly reduced CEO Kenneth Lewis’s total compensation in 2008 by 60% to \$9.96 million after the company missed performance targets (Mr. Lewis received \$24.8 million in 2007). Numerous companies have recently announced “say on pay” resolutions, and now include a proposal on shareholder proxy statements giving shareholders a nonbinding vote on executive pay. Perhaps most interestingly, some executives are refusing to take additional compensation. Johnson & Johnson CEO William Weldon reportedly turned down an increase in his base pay that was recommended by the company’s compensation committee earlier this year.

Corporate governance standards and the judicial attitude toward executive compensation have both changed since the *Disney* decision in 2006. As the economic turbulence continues and the expected “bailouts” mount, the *Citigroup* decision might increase the volume of shareholder litigation and further test the Delaware judiciary’s willingness to intervene in the merits of these disputes.

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