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Article

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For all of the howls of protest and handwringing about executive compensation in the United States over the past thirty years, it is remarkable how little has been done to clamp down on allegedly excessive pay.[1] Given the tremendous public pressure for change, one would think that policy reforms would have resolved these issues by now. Yet, to date, compensation activists have not persuaded Congress, state legislators, the Securities and Exchange Commission (SEC), or the courts to engage in major reforms.[2] Reforms that have been tried, such

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1. *See, e.g.*, Gretchen Morgenson, *Imperfect Politics of Pay*, N.Y. TIMES, Aug. 9, 2009, at BU1, *available at* 2009 WLNR 15396024; Floyd Norris, *A Window Opens on Pay for Bosses*, N.Y. TIMES, Jan. 15, 2010, at B1, *available at* 2010 WLNR 880749; Colin Barr, *Obama Talks Tough on CEO Pay*, FORTUNE, Feb. 4, 2009, http://money.cnn.com/2009/02/04/news/obama.exec.pay.fortune/index.htm. In the last two years, longstanding concern over executive pay has been exacerbated by bonuses paid at firms receiving aid through the Troubled Asset Relief Program (TARP).

2. In the past year, the federal government has intervened to limit compensation at firms that received funds from the TARP program; however, this

as requirements that most executive compensation be incentive-based[3] or nonbinding say-on-pay shareholder votes,[4] have done little to slow the growth of executive pay.[5]

While the public apparently believes that change is needed, not all theorists agree; indeed, a lack of consensus among theorists that a new system is needed may be a significant barrier to change. Advocates of one school of thought, Optimal Contracting, argue that there has been little action because there is no real problem.[6] They believe that most boards are negotiating the best possible CEO compensation arrangements (including employment contracts) in order to maximize shareholder value given the underlying contracting costs, such as the current corporate governance system in the United States.[7] Optimal Contracting theorists contend that the existing executive compensation system is largely working fine and that little change is needed to ensure that shareholders are getting their money's worth.[8]

In light of the recent deluge of academic and popular criticism of executive pay as well as recent legislation in this area, the belief that the American executive compensation system

intervention has been limited to a relatively small number of firms, and several firms have moved to pay back the funds so they will no longer be under the federal limits. *See* TARP Standards for Compensation and Corporate Governance, 31 C.F.R. § 30 (2009); David Enrich & Deborah Solomon, *Citi, Wells to Repay Bailout*, WALL ST. J., Dec. 15, 2009, at A1.

3. *See, e.g.*, Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, 107 Stat. 312 (1993). Since 1994, corporations have been forbidden to deduct compensation in excess of $1 million paid to their top five officers unless this compensation is performance-based. JAMES D. COX & THOMAS LEE HAZEN, CORPORATIONS § 11.06, at 235 (2d ed. 2003).

4. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 951, 124 Stat. 1376, 1899–900 (2010) (to be codified at 15 U.S.C. § 78n-1).

5. However, such votes continue as a means of expressing shareholder dissatisfaction. *See, e.g.*, *Nay on Pay: America's Shareholders Find a Voice to Condemn Undeserved Compensation*, ECONOMIST, May 15, 2010, at 70, 70 (discussing negative shareholder votes at Motorola and Occidental Petroleum).

6. *See, e.g.*, John E. Core et al., *Is U.S. CEO Compensation Inefficient Pay Without Performance?*, 103 MICH. L. REV. 1142, 1160 (2005); John E. Core & Wayne R. Guay, Is There a Case for Regulating Executive Pay in the Financial Services Industry? 2–6, 15–19 (Jan. 25, 2010) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1544104.

7. Core et al., *supra* note 6, at 1161.

8. *See* Michael B. Dorff, *The Group Dynamics Theory of Executive Compensation*, 28 CARDOZO L. REV. 2025, 2029 (2007).

works well is a distinctly minority position.[9] Far more popular is the well-worn Board Capture theory of American corporate governance, which claims that corporations' executives—particularly the chief executive officer (CEO)—dominate their boards of directors and, in essence, set their own pay.[10] Board Capture provides an underlying justification for overhauling the entire system and its supporters have pressed for sweeping changes to the current system.[11] Obviously, there is a stark contrast between the policies favored by Optimal Contract advocates and Board Capture theorists.

This Article aims to cut through the political and scholarly deadlock over executive compensation by providing a new solution to potential abuses of the executive-pay-setting process. It begins by assuming that the critics are right, and there is a need to rein in outlier pay packages.[12] We argue that a new role should be assumed by a branch whose effectiveness is oddly discounted by the most severe critics of executive compensation: the courts.[13] We demonstrate that, contrary to received wisdom, courts have from time to time engaged in serious review of executive compensation practices and pay packages.[14] However, they usually worked within the confines of the waste doctrine, which is much too weak to lead to meaningful scrutiny in most cases.[15] Today, courts have a stronger doctrine they

9. *See generally* TARP Standards for Compensation and Corporate Governance, 31 C.F.R. § 30 (2009); LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE 189 (2004); Lucian A. Bebchuk & Holger Spamann, *Regulating Bankers' Pay*, 98 GEO. L.J. 247, 287 (2010); J. Robert Brown, Jr., *Returning Fairness to Executive Compensation*, 84 N.D. L. REV. 1141, 1141 (2008); Miriam A. Cherry & Jarrod Wong, *Clawbacks: Prospective Contract Measures in an Era of Excessive Executive Compensation and Ponzi Schemes*, 94 MINN. L. REV. 368, 368–69, 373–75 (2009); Press Release, U.S. Dep't of Treasury, Interim Final Rule on TARP Standards for Compensation and Corporate Governance (June 10, 2009), *available at* http://www.treas.gov/press/releases/tg165.htm.

10. *See* BEBCHUK & FRIED, *supra* note 9, at 61–79.

11. *See, e.g.*, Bebchuk & Spamann, *supra* note 9, at 283.

12. Though one of us has written in support of optimal contracting, see Core et al., *supra* note 6, for purposes of this paper we assume the correctness of the elements of Board Capture theory, and ultimately argue that advocates of both sides should welcome the solution we propose here.

13. *Cf.* BEBCHUK & FRIED, *supra* note 9, at 45 ("Courts are simply ill equipped to judge the desirability of compensation packages and policies.").

14. *See* Randall S. Thomas & Kenneth J. Martin, *Litigating Challenges to Executive Pay: An Exercise in Futility?*, 79 WASH. U. L.Q. 569, 573–85 (2001).

15. *See infra* notes 131–45 and accompanying text. While we doubt that waste can provide a meaningful limit on excessive compensation, others disagree. *See generally* Steven C. Caywood, Note, *Wasting the Corporate Waste*

can employ when called on to monitor abuses in executive compensation: the fiduciary duties of officers.[16] As we show, recent Delaware court decisions have given new life to officers' fiduciary duties, not only by establishing that officers are bound by the same fiduciary duties as are directors, but by finding that officers' fiduciary duty of loyalty has special application when those officers are negotiating their own compensation agreements.[17] These decisions give the state's judiciary the power to police executive compensation by throwing out executive employment contracts that have been negotiated disloyally—that is, not in an arm's-length and adversarial manner.[18] Since a key assumption of Board Capture theory is that the executive officers of America's public corporations (especially CEOs) dominate the boards of directors charged with managing those corporations, empowering the courts to overturn outlier compensation agreements produced by illegitimate managerial power will attack a perceived major weakness in our corporate governance system.

In making this argument, we do not adopt Board Capture theory wholesale. Indeed, while accepting arguendo the Board

Doctrine: How the Doctrine Can Provide a Viable Solution in Controlling Excessive Executive Compensation, 109 MICH. L. REV. 111 (2010).

16. *See* Gantler v. Stephens, 965 A.2d 695, 708–09 (Del. 2009) (holding that officers owe fiduciary duties of care and loyalty). Until very recently, only a handful of articles have addressed officers' fiduciary duties, an omission discussed more fully in Part IV. *See, e.g.*, Donald C. Langevoort, *Agency Law Inside the Corporation*: *Problems of Candor and Knowledge*, 71 U. CIN. L. REV. 1187, 1196 (2003); A. Gilchrist Sparks, III & Lawrence A. Hamermesh, *Common Law Duties of Non-Director Corporate Officers*, 48 BUS. LAW. 215, 217 (1992). Despite the voluminous debate over executive compensation, only one other article has seen officers' fiduciary duties as a tool for limiting executive compensation. *See* Douglas C. Michael, *The Corporate Officer's Independent Duty as a Tonic for the Anemic Law of Executive Compensation*, 17 J. CORP. L. 785, 786–87 (1992) (contending that officers should be found to have a "duty not to accept unreasonable compensation"). This latter article recommends that courts use officers' fiduciary duties to engage in a sweeping review of compensation for its reasonableness, but anticipates our approach in concluding that a court should include in its inquiry whether "the negotiation process was fair and there was no overreaching." *Id.* at 824.

17. *See infra* notes 254, 257–58, 263–66 and accompanying text.

18. Here we focus on Delaware, but we recognize that approaches taken by Delaware's judiciary can influence approaches in other jurisdictions, and we hope that courts in other states would adopt the approach we advocate here. We would also note that this approach is not restricted to employment contracts, but could be applied with equal vigor to any other contractual agreement negotiated between the executive and the company, including severance agreements, change-in-control agreements, bonus plans, stock option agreements, etc.

Capture theorists' claim that the executive compensation system is broken, we reject another major claim made by advocates of Board Capture: that courts will refuse in almost all instances to scrutinize executive pay, instead deferring to the superior knowledge of boards of directors, and declining to act as human resource departments by second-guessing pay levels.[19] To the contrary, a significant element in our argument is historical, as we show that courts have—at moments in the past—proved willing to impose heightened scrutiny on executive pay.[20] With Delaware's new emphasis on officers' fiduciary duties, courts can and should assume such a role again.

In Part I of this Article, we lay out the fundamental claims of the most rigorous and articulate critique of current compensation practices—Board Capture theory.[21] In Part II, we examine the development of Board Capture theory in order to demonstrate that Board Capture—and worries over excessive executive compensation—have a long history.[22] This development began with the classic work on corporate governance by Adolf A. Berle, Jr. and Gardiner A. Means,[23] and continues in an unbroken chain to today.[24] It also formed the backdrop of early challenges to executive compensation in the courts that we discuss in Part III.[25] There we show that, while most courts have deployed the waste doctrine to test compensation and have claimed that they are reluctant to closely examine executive pay levels and practices, at moments in the past courts have indicated a willingness to apply more careful scrutiny to pay decisions.[26] Also contrary to received wisdom, shareholders during these periods have enjoyed some success in the courts when challenging pay arrangements.[27]

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19. *See* BEBCHUK & FRIED, *supra* note 9, at 45–46 ("[J]udicial review has failed to impose any meaningful constraint on executive pay."). *But see* Thomas & Martin, *supra* note 14, at 571 (finding that "shareholders are successful in at least some stage of the litigation process in a significant percentage of these cases").

20. *See infra* Part III.

21. *See infra* Part I.

22. *See infra* Part II.

23. ADOLF A. BERLE, JR. & GARDINER A. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1933).

24. *See, e.g.*, BEBCHUK & FRIED, *supra* note 9, at 23–44.

25. *See infra* Parts II, III.

26. *See infra* Part III.

27. *See infra* Part III.

In Parts IV and V, we show how recent Delaware judicial decisions on officers' fiduciary duties can give courts in that state a new and active role in overseeing executive compensation.[28] Part IV analyzes the emergence of officers' distinct fiduciary duties, focusing on the developments in Delaware case law that culminated with the Delaware Supreme Court's holding in *Gantler v. Stephens*[29] that corporate officers owe the same fiduciary duties as directors.[30] Part V shows how these decisions should change executive compensation practices.[31] It first discusses recent decisions by the Delaware chancery court indicating that officers' fiduciary duties come into play when officers negotiate compensation agreements with their corporations.[32] It then contends that courts following these decisions can limit executive overreaching in excessive compensation agreements by applying a rigorous standard of review to CEOs' and other senior officers' conduct when negotiating those compensation agreements with their firms.[33] New judicial recognition of officers' fiduciary duties, and consequent close scrutiny of actions implicating those duties, will discipline compensation in two ways. First, ex ante, it will improve the overall contracting environment by encouraging officers to disclose fully any questionable negotiating behavior prior to board approval of their compensation agreements, or simply to avoid such behavior. These steps would level the playing field by reducing information asymmetries between boards and corporate officers. Second, ex post, it will lead courts to carefully review the negotiations that lead to compensation agreements, being especially alert for the self-interested maneuvers that Board Capture theorists believe characterize such negotiations.

Finally, in Part VI we return to theory. Having argued that the shift in judicial review proposed here will be welcomed by advocates of Board Capture, we ask how it will be viewed by advocates of Optimal Contracting.[34] We conclude that, from an Optimal Contracting perspective, reinvigorated judicial policing of abuses in the contracting process between boards and officers will improve both the underlying corporate governance sys-

28. *See infra* Parts IV, V.
29. 965 A.2d 695 (Del. 2009).
30. *Id.* at 708.
31. *See infra* Part V.
32. *See infra* text accompanying notes 254–68.
33. *See infra* text accompanying notes 300–12.
34. *See infra* Part VI.

tem and the quality of executive employment agreements.[35] Thus, the proposals made here should be welcomed by, and will help transcend the differences between, advocates of both views of executive compensation.

I. BOARD CAPTURE THEORY AND THE COURTS

A. BRIEF OVERVIEW

Board Capture theory,[36] or what its most recent proponents, Lucian Bebchuk and Jesse Fried, have called the Managerial Power Perspective,[37] claims that executive compensation practices in the United States benefit corporate executives at the expense of shareholders.[38] Managerial power arises, this theory claims, because boards of directors at public companies are beholden to the firm's CEO and other top executives, largely due to management's control over the director nomination process.[39] Weak boards, and more particularly weak compensation committees, do little to protect firms in their pay negotiations with officers.[40] The result is executive pay that is both excessive, in that it exceeds what a competitive market for managerial talent characterized by adversarial arm's-length bargaining would produce, and poorly designed, in that it is not sufficiently tied to the executive's performance.[41]

Without the captured board to act as their faithful agent, shareholders are left with no other meaningful checks on executive pay.[42] Shareholders' other tools for influencing execu-

35. *See infra* Part VI.

36. *See* Randall S. Thomas, *Explaining the International CEO Pay Gap: Board Capture or Market Driven?*, 57 VAND. L. REV. 1171, 1174–75 (2004) (explaining the theory and questioning its usefulness as an explanation of international pay differences).

37. BEBCHUK & FRIED, *supra* note 9, at 61.

38. *See, e.g.*, Thomas, *supra* note 36, at 1174–75 & n.5.

39. *See id.* at 1174 n.5; *see also* COX & HAZEN, *supra* note 3, § 9.01 & n.3, at 136.

40. *See* BEBCHUK & FRIED, *supra* note 9, at 80, 82 (noting that managers have more power when "the board is relatively weak or ineffectual" and that "CEOs obtain more favorable pay arrangements when they are more powerful," and further discussing how the relationship between the CEO and members of the compensation committee affects executive compensation).

41. *See id.* at 6.

42. *See id.* at 45–58, 65–66 (discussing the failures of shareholder interventions and market forces to provide a check on executive compensation arrangements, and further noting that "outrage" by relevant outsiders will deter the adoption of otherwise favorable executive pay arrangements, but the out-

tive pay levels, for instance voting in favor of shareholder resolutions to restrict pay, voting against management-sponsored option plans, or filing lawsuits, are indirect and weak.[43] Recent proposals to provide for an advisory shareholder vote on executive remuneration[44] seem unlikely to change Board Capture theorists' belief that shareholders have no effective mechanism for limiting top officers' pay.[45] When it comes to shareholder voting, the New York Stock Exchange and NASDAQ rules require shareholder votes on all stock option plans,[46] but Board Capture theorists do not believe that this meaningfully constrains executive compensation levels.[47] Stock option plans are almost always approved, and even when shareholders reject them, directors can authorize alternative forms of executive pay.[48] In sum, Board Capture theorists believe that "shareholder voting on option plans has been a weak constraint on compensation arrangements."[49]

Markets represent another potential check on executive pay levels, but according to Board Capture theorists they are also weak constraints on managers' remuneration.[50] In the managerial labor market, if the primary determinant of an officer being hired by another firm is the officer's performance, not prior pay level, then officers might as well get all they can from their current firm because their current salaries will not affect their marketability.[51] Furthermore, if an executive re-

rage "must be sufficiently widespread among a relevant group" in order "to impose significant costs").

43. *See id.* at 45–52 (discussing the limited power of shareholders to intervene).

44. *See, e.g.*, *Fact Sheet: Ensuring Investors Have a "Say on Pay"*, U.S. DEPARTMENT TREASURY, http://www.ustreas.gov/press/releases/reports/fact_sheet_say%20on%20pay.pdf (last visited Nov. 29, 2010) (discussing the Obama Administration's support for the SEC's say-on-pay proposals); *see also* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 951, 124 Stat. 1376, 1899–900 (2010) (to be codified at 15 U.S.C. § 78n-1).

45. *Cf.* Brian R. Cheffins & Randall S. Thomas, *Should Shareholders Have a Greater Say over Executive Pay?: Learning from the U.S. Experience*, 1 J. CORP. L. STUD. 277, 307–10 (2001) ("Traditionally, when shareholders in US companies have been called upon to consider stock option plans, such schemes have been approved with almost no opposition." (citation omitted)).

46. *See* NASDAQ LISTING RULE 5635 (2010); NYSE LISTED COMPANY MANUAL § 303A.08 (2010).

47. *See* BEBCHUK & FRIED, *supra* note 9, at 49.

48. *See id.* at 48–51 (discussing shareholder voting on stock option plans).

49. *Id.* at 51.

50. *See id.* at 53.

51. *Id.* at 54.

ceives an external offer of employment, it will raise the executive's pay, since the competing firm must offer more than the executive's old pay in order to induce her to leave her current employer.[52] The market for corporate control does no better. In principle, high executive compensation levels could lead to a drop in a firm's stock price, making the firm more vulnerable to a potential takeover.[53] Thus, an officer's fear of a takeover would in theory limit excessive pay. But, as Board Capture theorists note, hostile takeovers are rare, and even if one occurs, departing executives are frequently given "golden parachutes" and other types of lucrative severance payments.[54] Overall, Board Capture theorists believe that executives gain far more from higher compensation today than they lose through any increased likelihood of a takeover that could result from excessive executive pay.[55]

Capital markets also cannot constrain executive pay, according to Bebchuk and Fried.[56] Firms rarely raise equity capital.[57] Even when they do, high executive pay does not cut off a firm's access to the equity markets, but simply raises the firm's cost of getting equity capital.[58] Product markets do no better at limiting pay; they are rarely competitive, and even when they are, high pay seems unlikely to adversely affect a firm's operational efficiency.[59] Moreover, despite such effects, executives would still gain more from higher pay today than they would lose from the increased risk of firm failure tomorrow.[60] In short, market forces seem likely only to deter managers from extreme deviations from arm's-length contracting arrangements.[61]

Finally, and most important for this Article, Board Capture theorists believe that shareholder litigation is only a very limited check on excessive executive pay plans.[62] They argue that courts are ill equipped to judge the desirability of compensation levels and practices, and therefore judges typically apply the highly deferential business judgment rule when evaluating ex-

52. *See id.*
53. *See id.* at 55–56.
54. *See id.*
55. *Id.* at 56.
56. *See id.* at 56–57.
57. *Id.* at 56.
58. *Id.* at 57.
59. *See id.*
60. *See id.*
61. *Id.* at 58.
62. *See id.* at 45.

ecutive pay levels (unless there are serious duty-of-care issues or flaws in the board approval process).[63] In fact, Bebchuk and Fried note that "almost all cases since 1900 have refused to overturn compensation decisions made by the boards of publicly traded firms."[64]

B. LITIGATION'S ROLE

Board Capture theorists "do not believe that the problems of executive compensation can be addressed by judicial intervention."[65] They claim that litigation is a weak, almost nonexistent limit on executive pay because courts are too quick to apply the business judgment rule and are loath to second-guess boards on compensation amounts.[66] In their eyes, courts lack the institutional capacity to review the substance of executive compensation agreements—they "are simply ill equipped to judge the desirability of compensation packages and policies."[67] So long as corporations follow fairly easy procedural requirements—having a compensation committee composed of "nominally independent and informed directors" approve all compensation packages and seeking the advice of compensation experts—courts will not inquire into the substance of their decisions or even look too closely at the process.[68] Theoretically, litigants can still claim that a compensation package is so egregious as to constitute waste,[69] but that standard is almost never met.[70] And even before they get their day in court, shareholder litigants filing a derivative suit must overcome the demand requirement, which allows boards in almost all instances to seize control of shareholder litigation.[71] In sum, Board Capture theorists believe that so long as a board compensation committee properly papers its compensation deci-

63. *See id.* at 45–46.

64. *Id.* at 46 (citations omitted). *But cf.* Thomas & Martin, *supra* note 14, at 571 (finding that shareholders are typically successful in at least some stage of suits in which they seek to challenge executive pay).

65. BEBCHUK & FRIED, *supra* note 9, at 45.

66. *See id.* at 45–46.

67. *Id*. at 45.

68. *Id.* at 46.

69. One definition finds waste when "an exchange . . . is so one sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration." Brehm v. Eisner, 746 A.2d 244, 263 (Del. 2000) (citations omitted).

70. *Id.*

71. *See* BEBCHUK & FRIED, *supra* note 9, at 46–47 (discussing the demand requirement).

sions, receives "relevant materials[,] and spends some time examining them," courts will not intervene.[72]

But what if courts' roles in monitoring executive compensation could be strengthened? The development and implementation of clearer and more manageable doctrine concerning executive compensation should result in more aggressive judicial monitoring of executive overreaching and improved contracting between boards and executives. There is evidence that stronger judicial review has had this effect for closely held corporations.[73] Courts, for instance, have applied a reasonableness test to determine for tax purposes whether executive pay is in part a disguised dividend to officers/shareholders.[74] Enhanced judicial scrutiny under the reasonableness test (as well as the predominance of inside directors) has significantly increased shareholders' success rates when they bring executive compensation cases against close corporations.[75]

If judicial review could be improved, then it would have at least two beneficial effects on the relationship between boards and officers. First, from an ex ante perspective, officers would have strong incentives to avoid altogether, or at least make full disclosure of, any potentially improper relationships or conflicts of interest that they might have in their negotiations with their firms in order to head off potential litigation. This would reduce information asymmetries between directors and officers. Second, from an ex post perspective, stricter scrutiny could remedy situations where a contract is negotiated one-sidedly in favor of an executive, thereby curing any overreaching in contract negotiations.

The approach we propose—giving courts greater power to scrutinize executive compensation to both improve the negotiating environment and to curb particularly one-sided negotiations—may appear a radical break from past practices. It is not. In the next two Parts, we will show that neither the fears that Board Capture has skewed executive compensation, nor courts' attempts to curb it, are new.

72. *Id.* at 48.

73. Thomas & Martin, *supra* note 14, at 586–87.

74. Detlev Vagts, *Challenges to Executive Compensation: For the Markets or the Courts?*, 8 J. CORP. L. 231, 252–61 (1983) (contending that courts examining CEO pay at public companies should borrow from tax and close corporation cases to test for reasonableness of compensation by comparing compensation levels of executives at similar firms).

75. Thomas & Martin, *supra* note 14, at 586–87, 610.

II. THE EVOLUTION OF BOARD CAPTURE THEORY

While Board Capture theory and its impact on executive compensation have received a lot of recent press,[76] fears that managers will use their powers to divert corporate resources from shareholders to themselves are as old as the modern corporation. In *The Modern Corporation and Private Property*, the foundational text of modern corporate governance,[77] Berle and Means warned that the separation of ownership and control that marked the modern corporation gave management "almost absolute power" over the corporation, including virtually uncontrolled "power of confiscation of a part of the profit stream and even of the underlying corporate assets."[78] Here already is the kernel of the Board Capture hypothesis: the worry that managers will have unchecked power over corporate assets and, thereby, be able to serve their own interests rather than those of shareholders. While this account by Berle and Means differs from that presented by Bebchuk and Fried, they share the underlying suspicion that managers' rewards were, or could easily be, set by themselves and disconnected from shareholder value.[79]

The belief that executive compensation was systematically skewed by executives' power and was set without regard to increased shareholder value first became widespread in the early 1930s.[80] At that time, disclosures revealed that executives at a number of major corporations, including American Tobacco, Bethlehem Steel, and National City Bank, had received large bonuses in years when shareholders received no dividends, and that top executives at those firms took home "then-unthinkable sums" of over $1 million a year.[81] In response to what the public perceived as an epidemic of executive overcompensation,

76. Bebchuk and Fried discuss the "official story" of executive compensation, which they claim underlies corporate law on executive compensation and assumes that boards mitigate any agency problems created in negotiation of executive compensation agreements. BEBCHUK & FRIED, *supra* note 9, at 15–18.

77. *See, e.g.*, William W. Bratton, *Berle and Means Reconsidered at the Century's Turn*, 26 J. CORP. L. 737, 737–38 (2001).

78. BERLE & MEANS, *supra* note 23, at 127, 247.

79. *See* BEBCHUK & FRIED, *supra* note 9, at 121; BERLE & MEANS, *supra* note 23, at 138. Berle and Means differ most notably from Bebchuk and Fried in that they rarely differentiated between directors and officers, but lumped them together as "management." *Id.* at 127.

80. *See* Harwell Wells, *"No Man Can Be Worth $1,000,000 a Year": The Fight over Executive Compensation in 1930s America*, 44 U. RICH. L. REV. 689, 691 (2010).

81. *Id.* at 690, 709–15.

Congress considered numerous proposals, including punitive taxation of compensation packages, and included compensation disclosure requirements in the Securities Act of 1933 and the Securities Exchange Act of 1934.[82] Although there appears no way to gauge whether most executives were paid too much during this decade (i.e., whether their compensation systematically exceeded what would have been paid as the outcome of arm's-length bargaining), it is clear that most Americans believed this to be so.[83] In a 1936 poll, *Fortune* magazine found that most respondents, even those in the highest income bracket, thought that executives were overpaid.[84]

Executive compensation faded as an issue at the end of the 1930s.[85] It was slow to reemerge as a topic after the war, due in large part to the fact that levels of compensation were not as high after the war as during the 1930s.[86] During the late 1940s, average executive compensation actually decreased.[87] While it resumed its growth in the early 1950s, it grew at an average rate of only 0.8 percent a year, below average income growth.[88] By one estimate, executive compensation did not again attain the heights of the early 1930s until the end of the 1980s.[89]

That compensation was lower in the postwar era did not, however, lead observers to conclude that it was optimal or linked to shareholder value. Running through discussions of executive compensation, from the 1930s to today, is a consistent suspicion that it is set not by market forces, but by executives themselves. While one observer claimed that the prevailing assumption in the 1950s was that "the executive is paid at a rate roughly equal to his marginal contribution to company

82. *See id.* at 737–45.

83. *Cf. id.* at 707 (noting the belief that "some sums were so large that no one could 'deserve' them").

84. *Big Salaries*, FORTUNE, Apr. 1936, at 215.

85. Wells, *supra* note 80, at 758.

86. *See generally* GEORGE THOMAS WASHINGTON & V. HENRY ROTHSCHILD, 2ND, COMPENSATING THE CORPORATE EXECUTIVE 296–310 (rev. ed. 1951) (discussing wage stabilization); Mark Leff, *The Politics of Sacrifice on the Home Front During World War II*, 77 J. AM. HIST. 1296, 1298–306 (1991) (discussing the push for wage limits during World War II).

87. Carola Frydman & Raven E. Saks, *Executive Compensation: A New View from a Long-Term Perspective, 1936–2005*, 23 REV. FIN. STUD. 2099, 2106 (2010).

88. *Id.*; *see also* Carola Frydman, *Learning from the Past: Trends in Executive Compensation over the 20th Century*, 55 CESIFO ECON. STUD. 458, 473 (2009).

89. Michael C. Jensen & Kevin J. Murphy, *CEO Incentives—It's Not How Much You Pay, but How*, HARV. BUS. REV., May–June 1990, at 138, 138–39.

profits," commentators frequently challenged this view.[90] Much was made of studies that showed a close correlation, not between executive compensation and firm profits, but between compensation and firm size, and some economists saw in this a tool by which wily executives could increase their compensation at shareholders' expense.[91] In 1957, William Baumol argued that the correlation between executive compensation and firm size could systemically skew managerial behavior, leading managers motivated by "personal self-interest" to seek to maximize sales rather than, presumably, shareholder value in the form of profits.[92] In 1963, Oliver Williamson made an even more direct connection between managerial power and executive compensation, arguing that increased managerial discretion in the modern corporation created "a systematic effect on resource-allocation decisions."[93] This power enabled managers to increase their own emoluments, a term Williamson defined as economic rents, "not [as] a return to entrepreneurial capacity but rather . . . from the strategic advantage that the management possesses in the distribution of the returns to monopoly power."[94] When managers were prevented by the tax code or public scrutiny from taking additional compensation in higher

90. Herbert A. Simon, *The Compensation of Executives*, 20 SOCIOMETRY 32, 35 (1957). Simon describes this as the "usual economic explanation," but in retrospect what is striking is how many scholars dissented from it. *See, e.g.*, *id.* The main proponent of the view that compensation was linked to profits was probably the McKinsey & Co. consultant Arch Patton, and even he conceded that there was also a relationship between compensation and firm size. *See* ARCH PATTON, MEN, MONEY AND MOTIVATION at vii, 76–77 (1961).

91. *See, e.g.*, Robert J. Howe, *Price Tags for Executives*, HARV. BUS. REV., May–June 1956, at 94, 98; Joseph W. McGuire et al., *Executive Incomes, Sales and Profits*, 52 AM. ECON. REV. 753, 755–61 (1962) (finding a relationship between current executive compensation and past sales); *see also* Xavier Gabaix & Augustin Landier, *Why Has CEO Pay Increased So Much?*, 123 Q.J. ECON. 49, 50, 67–69 (2008) (finding that the size of a firm explains much recent growth in CEO pay); Richard L. Shorten, Jr., Note, *An Overview of the Revolt Against Executive Compensation*, 45 RUTGERS L. REV. 121, 141–43 (1992) (discussing historical connections between firm size and executive compensation).

92. WILLIAM J. BAUMOL, BUSINESS BEHAVIOR, VALUE AND GROWTH 46–47 (1959). Baumol was not the only writer of the era who believed that management was no longer required to maximize profits and, more generally, that management was the effective controller of the corporation. *See generally* JOHN KENNETH GALBRAITH, THE NEW INDUSTRIAL STATE (1967); ROBIN MARRIS, THE ECONOMIC THEORY OF 'MANAGERIAL' CAPITALISM (1964); Henry L. Tosi, *Theory of Managerial Capitalism*, *in* THEORIES OF ORGANIZATION 169, 169 (Henry L. Tosi ed., 2009).

93. Oliver E. Williamson, *Managerial Discretion and Business Behavior*, 53 AM. ECON. REV. 1032, 1032 (1963).

94. *Id.* at 1035.

wages, he concluded, they would take them through perquisites which were "much less visible rewards to the management than salary and hence are less likely to provoke stockholder or labor dissatisfaction."[95]

Neither was the board believed to be a significant check on executive self-dealing. The term Board Capture was not used in the 1950s, but similar ideas were commonplace. The law held then, as it does now, that the board of directors was the "supreme and original authority" in the corporation,[96] but the general perception was that power was held by a corporation's chief executive.[97] In an era before adoption of the model of a "monitoring" board, the board of directors was more often seen as a sort of cabinet of advisors to the chief executive, rather than as a supervisory body.[98] This was reflected by the ubiquity of the "inside" board, which consisted of a majority of directors who were either corporate officers or otherwise affiliated with the firm.[99] According to data assembled by Jeffrey Gordon, in 1950 approximately half of all directors of a sample of large public firms were "inside" directors, with another quarter being "affiliated" directors, a pattern that would persist into the 1970s.[100] In 1958, the management consultant and board expert Everett Smith wrote that, "for all practical purposes, the board is a creature of the chief executive."[101] Thirteen years

95. *Id.*

96. HENRY WINTHROP BALLANTINE, BALLANTINE ON CORPORATIONS 119 (rev. ed. 1946).

97. Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950–2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1511 (2007).

98. Jeffrey Gordon dates the rise of the monitoring model of the board of directors to the 1970s. *Id.* at 1514; *see also* STEPHEN M. BAINBRIDGE, THE NEW CORPORATE GOVERNANCE IN THEORY AND PRACTICE 160–61 (2008) (discussing the emergence of a monitoring board). While discredited today, there was a tradition of regarding an "internal board" as an improvement on other models. In the 1930s, there was a widespread perception that boards had often failed because of uninvolved outside directors. One study done by the Temporary National Economic Commission in 1940 reported that "the only boards that functioned were those with a 'hearty sprinkling of members who were officers.'" Philip A. Loomis, Jr. & Beverly K. Rubman, *Corporate Governance in Historical Perspective*, 8 HOFSTRA L. REV. 141, 157 (1979) (quoting TNEC Monograph No. 11).

99. *See* THE DIRECTOR LOOKS AT HIS JOB 139 (Courtney C. Brown & E. Everett Smith eds., 1958) (writing of the "usual board, composed of a number of operating management supplemented by outsiders who come together for perhaps part of a day once a month").

100. *See* Gordon, *supra* note 97, at 1472–76, app. at 1565.

101. E. Everett Smith, *Put the Board of Directors to Work!*, HARV. BUS. REV., May–June 1958, at 41, 43.

later Myles Mace wrote in his classic study *Directors: Myth and Reality*, that, in a public corporation with dispersed shareholders, "the president . . . typically does have the de facto powers to control the enterprise, and with these powers of control it is the president who . . . determines in large part what the board of directors does or does not do."[102]

With no evidence either that executive pay was closely correlated to shareholder value or that the board was a significant check on managers' actions, many concluded that executive compensation was set not by the market but by executives themselves. That was the popular impression. In a survey of shareholders in 1958, the business journalist James Livingston asserted that executives had the "power to overpay themselves," and that an executive making a compensation contract was "tantamount to making a contract with himself."[103] Academic studies bolstered this view. In an influential 1956 article, the economist David Roberts examined the market for executives and concluded that there was not much of one.[104] His evidence showed that the vast majority of executives were promoted from within their firms, that few executives ever changed firms ("extreme immobility is the general case"), and that low-paying firms did not tend to lose executives at a greater rate than other firms.[105] These findings, he argued, seriously weakened "the concept of a 'market for executives,' and accordingly [supported the claim that] market forces can be expected to exert only a loose constraint over the firm's executive compensation."[106]

Even before these studies, George T. Washington and Henry Rothschild, the authors of the era's leading text on executive compensation, had noted that managers in corporations without strong external investor involvement tended to be paid more.[107] This finding strongly hinted at managerial power over

102. MYLES L. MACE, DIRECTORS: MYTH AND REALITY 191 (1971).

103. J.A. LIVINGSTON, THE AMERICAN STOCKHOLDER 222, 230 (1958); *accord* 1 GEORGE THOMAS WASHINGTON & V. HENRY ROTHSCHILD, 2ND, COMPENSATING THE CORPORATE EXECUTIVE 27 (3d ed. 1962) (discussing the many arguments "that management is in control of the company, sits on both sides of the table, and is thus able to fix its own pay without regard for the interests of stockholders").

104. *See* David R. Roberts, *A General Theory of Executive Compensation Based on Statistically Tested Propositions*, 70 Q.J. ECON. 270, 293 (1956).

105. *Id.* at 293 n.5.

106. *Id.* at 293.

107. WASHINGTON & ROTHSCHILD, *supra* note 86, at 419.

compensation: "Corporations whose managements are not subject to control by large stockholders or by financial interests tend to give higher rewards to management than companies in which those controls are present."[108] They later acknowledged that, in salary negotiations, "the company's representative . . . may not be sufficiently hard-boiled in his attitude, particularly where one of the present managers is concerned. Lack of effective bargaining on behalf of the stockholders' interest has sometimes been apparent."[109] In 1958, Professors Robert Mautz and Gerald Rock went further: "In the final analysis managerial compensation is not controlled by shareholders; it is not controlled by directors; it is not controlled by the courts. . . . The ultimate present control is the integrity and conscientiousness of management."[110]

Executive compensation continued to be a concern through the 1960s and 1970s,[111] but the modern debate over compensation was not rekindled until the end of that decade. Then, executives' compensation—particularly the compensation of CEOs—began to grow at an accelerating pace even as average workers' wages stagnated and concern spread about whether executives were providing American firms with effective leadership against overseas challengers.[112] The broad trends are well-known. In 1965, the average U.S. CEO of a major company earned twenty-four times more than a typical worker; in 1989, the CEO earned seventy-one times more than a typical worker; by 2007, the CEO earned 275 times more than a typical worker.[113]

108. *Id.*

109. *Id.* at 23.

110. Robert B. Mautz & Gerald W. Rock, *The Wages of Management*, 11 U. FLA. L. REV. 474, 508 (1958).

111. The academic debate had its twists and turns. In the 1970s, for instance, following a work by Wilbur Lewellen and Blaine Huntsman, some studies did find correlations between compensation and profits. Shorten, *supra* note 91, at 142 (citing Wilbur G. Lewellen & Blaine Huntsman, *Managerial Pay and Corporate Performance*, 60 AM. ECON. REV. 710, 717–18 (1970)).

112. GRAEF S. CRYSTAL, IN SEARCH OF EXCESS: THE OVERCOMPENSATION OF AMERICAN EXECUTIVES 27, 30 (1991).

113. LAWRENCE MISHEL ET AL., THE STATE OF WORKING AMERICA 2008/2009, at 220 (2009) (comparing CEO pay at 350 large, publicly owned industrial and service companies against the typical hourly wage of production/nonsupervisory workers).

In an effort to explain these results, scholars again turned their attention to managerial power.[114] In a 1977 critique of high compensation, John C. Baker, who had pioneered the study of executive compensation forty years prior, identified executives' power as a key reason for rising compensation.[115] "Although approval by the board of directors and stockholders may be required," he wrote, "the final agreement on executive rewards lies with the senior management echelon. No group in the power structure is more influential in deciding their rewards than the involved executives themselves."[116] Nor did the board exercise much supervision over compensation. With inside directors being corporate officers, and so dependent on the executive, and outside directors also "beholden to top management" for their position, the notion that the board would "independently exercise final power over the adoption of compensation programs" was mistaken.[117] Intriguingly, Baker also anticipated future work on executive compensation when he identified "[c]onsultants, accounting firms, lawyers, and others" as playing "a far more important role than is generally recognized" in setting compensation levels, pointing out that these groups were also beholden to management, depending "on senior executive approval for their substantial fees[,] and their continuing employment."[118]

By the 1990s, such criticisms were voiced by many critics of executive compensation.[119] Perhaps the best known was the compensation consultant Graef Crystal, who in his 1991 book, *In Search of Excess*, launched an attack on executive compensation practices that anticipated the Board Capture thesis.[120] Crystal explicitly rejected the claim that high executive pay was the result of arm's-length negotiations between informed buyers and sellers, and instead argued that it was a product of

114. Although some scholars pointed to managerial power, others disagreed. *Cf.* Kevin J. Murphy, *Top Executives Are Worth Every Nickel They Get*, HARV. BUS. REV., Mar.–Apr. 1986, at 125 (arguing that "[t]he pay and performance of top executives are strongly and positively related").

115. *See* John C. Baker, *Are Corporate Executives Overpaid?*, HARV. BUS. REV., July–Aug. 1977, at 51, 53.

116. *Id.*

117. *Id.*

118. *Id.*

119. *See, e.g.*, CRYSTAL, *supra* note 112, at 42–50.

120. *See id. passim.*

the power chief executives systematically wielded over their boards.[121]

In the legal academy, Charles Elson identified Board Capture as a major problem in a series of articles in which he pointed to managerial domination of the board as a major cause of excessive executive compensation. As a solution, he advocated for changes in the way directors were compensated as a way to "break management's grip on the board."[122] The idea resurfaced again in Bebchuk, Fried, and David I. Walker's 2002 article, *Managerial Power and Rent Extraction in the Design of Executive Compensation*,[123] and of course most recently in Bebchuk and Fried's book, *Pay Without Performance*.[124]

Neither popular nor scholarly dissatisfaction with executive compensation is new; nor, as we show below, have courts always been complacent when it comes to how much companies pay executives. In fact, Board Capture theory has formed the backdrop of judicial review for the last several decades. The difficult question has been what, if anything, courts would actually do about executive compensation.

121. *See id.* at 226–27 (describing the compensation committee as "at the mercy of whatever the CEO wants to tell them," and describing the CEO as "boss of all the outside directors"). Crystal rejects the notion that the compensation system is fundamentally sound, and charges that it is "rotten to the core." *Id.* at 29–31. Understandably, he also gives a prominent role to compensation consultants, whom he sees as beholden to the CEO. *Id.*

122. Charles M. Elson, *Director Compensation and the Management-Captured Board—The History of a Symptom and a Cure*, 50 SMU L. REV. 127, 127, 133 (1996); *see also* Charles M. Elson, *Executive Overcompensation—A Board-Based Solution*, 34 B.C. L. REV. 937, 947–48 (1993); Charles M. Elson, *The Duty of Care, Compensation, and Stock Ownership*, 63 U. CIN. L. REV. 649, 650–51 (1995). Other legal scholars had recognized far earlier that whatever the law's dictates "most of the powers supposedly vested in the board are actually vested in the executives." Melvin Aron Eisenberg, *Legal Models of Management Structure in the Modern Corporation: Officers, Directors, and Accountants*, 63 CALIF. L. REV. 375, 376 (1975); *see also* Michael, *supra* note 16, at 823 ("Executive compensation in public corporations has grown out of control because the duty to control it has been placed by the law largely in the hands of those who have no ability to do so: the board of directors.").

123. Lucian Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 751 (2002).

124. BEBCHUK & FRIED, *supra* note 9, at 61–74.

III. EXECUTIVE COMPENSATION IN THE COURTS: A SHORT HISTORY

Courts, including Delaware courts, have long been wary of second-guessing executive compensation.[125] Contrary to the views of some Board Capture theorists, however, this does not mean that courts have never been willing to inquire into executive compensation at public corporations. At a number of points over the last century, courts have threatened higher scrutiny for executive pay: the executive compensation cases of the 1930s,[126] the Delaware courts' stock options cases in the 1950s[127] and 1960s, and most recently in the *Disney* decisions.[128] These episodes show that judges have at times been troubled by executive compensation levels and practices and have moved to rein them in.[129] They also show, though, that courts have been frustrated by their inability to determine what constitutes appropriate pay, and unwilling simply to second-guess pay decisions or impose their own determinations of fairness on executive compensation.[130] One of the virtues of the approach this Article presents is that it responds to the need to monitor executive pay by allowing state courts to engage in familiar analysis of board decisionmaking processes rather than asking judges to become pay czars.

Courts' first major brush with executive compensation at public corporations occurred in a series of cases in the early 1930s.[131] Perhaps the most famous challenged a longstanding executive bonus plan at American Tobacco. The challenge reached the U.S. Supreme Court in 1933 and resulted in what

125. COX & HAZEN, *supra* note 3, § 11.05, at 227.

126. *See* Wells, *supra* note 80, at 717–37.

127. *See* Lewis v. Vogelstein, 699 A.2d 327, 336–37 (Del. Ch. 1997).

128. *See In re* Walt Disney Co. Derivative Litig., 907 A.2d 693 (Del. Ch. 2005), *aff'd*, 906 A.2d 27 (Del. 2006); *In re* Walt Disney Co. Derivative Litig., 731 A.2d 342 (Del. Ch. 1998), *aff'd in part, rev'd in part sub nom.* Brehm v. Eisner, 746 A.2d 244 (Del. 2000).

129. Broad assertions of judicial inactivity in the area of executive compensation also ignore studies showing that, despite courts' general deference to board decisions, shareholder suits challenging executive compensation practices at public and close corporations have enjoyed significant success at many stages of the litigation process. Thomas & Martin, *supra* note 14, at 571.

130. COX & HAZEN, *supra* note 3, § 11.05, at 228.

131. This episode is discussed at greater length in Wells, *supra* note 80, at 717–37. Before the 1930s, courts did scrutinize compensation decisions at close corporations in response to allegations of minority oppression or tax avoidance. *Id.* at 704–05.

appeared to be a landmark decision.[132] In that case, *Rogers v. Hill*, the plaintiffs argued that the receipt of a bonus of over $1 million by American Tobacco president G.W. Hill was so large as to violate the "waste" doctrine forbidding spoliation or gift of corporate assets.[133] In a unanimous decision, the Court appeared to agree—or at least agree that there was a point at which compensation could be so large as to constitute waste, irrespective of whether the compensation award was tainted by fraud or self-dealing.[134] The rule, the Court held, was that if "a bonus payment has no relation to the value of services for which it is given, it is in reality a gift in part and the majority stockholders have no power to give away corporate property against the protest of the minority."[135] The Court remanded to the district court for determination of whether the payment met this standard and so constituted waste.[136]

Rogers was a complex case with unusual facts. For one, the challenged bonus plan was not the result of the American Tobacco board's deliberation, but was dictated by a bylaw, in place since 1912, allotting senior managers a fixed percentage of the firm's profits.[137] At the time *Rogers* was decided, many saw it as the harbinger of greater judicial oversight of executive compensation and, specifically, greater scrutiny of large pay packages.[138] Its promise, however, was not fulfilled. The case settled out of court before the district court had a chance to pass on whether Hill's bonus constituted waste.[139] While a number of other suits were filed against public corporations during the rest of the decade, each alleging that compensation was so large as to constitute waste, in none did the court ultimately find that the compensation constituted waste.[140]

132. Rogers v. Hill, 289 U.S. 582 (1933). On the case's convoluted history, see Wells, *supra* note 80, at 717–27. While the decision in *Rogers* is terse, it appears to rest on federal common law. Before *Erie R.R. Co. v. Tompkins*, 304 U.S. 64 (1938), litigants could file claims in federal courts, and so take advantage of the federal common law of corporations, which in effect competed with Delaware common law. Bratton, *supra* note 77, at 768 & n.210 (discussing federal common law of corporations pre-*Erie*).

133. *Rogers*, 289 U.S. at 591.

134. *Id*. at 589–91.

135. *Id.* at 591–92 (citation omitted).

136. *Id.* at 592.

137. *Id.* at 584–85.

138. *See* Wells, *supra* note 80, at 717.

139. *See* WASHINGTON & ROTHSCHILD, *supra* note 86, at 390–91.

140. In some cases, though, courts found that boards had miscalculated bonus payments and found the board liable for sums paid that they had not

More significantly, by the late 1930s courts that were asked to determine whether a compensation package constituted waste effectively threw up their hands at the exercise, judging themselves unequipped to second-guess a legitimate business decision to pay an executive a particular amount.[141] In an influential 1939 case, *McQuillen v. National Cash Register Co.*, the court declined to find a stock option grant to the president of NCR wasteful.[142] It instead drew a distinction between "wasteful" compensation and "excessive" compensation: "[T]he former is unlawful, the latter is not."[143] Waste should only be found, it held, where there has been "a failure to relate the amount of compensation to the needs of the particular situation by *any* recognized business practices, honestly, even though unwisely adopted,—namely, the result of bad faith, or of a total neglect of or indifference to such practices."[144] In *Heller v. Boylan*, a 1941 case that involved yet another challenge to bonus payments at American Tobacco, a New York court was even more blunt about its incapacity to judge the substance of executive compensation decisions:

> Courts are ill-equipped to solve or even to grapple with these entangled economic problems. Indeed, their solution is not within the juridical province. Courts are concerned that corporations be honestly and fairly operated by its directors, with the observance of the formal requirements of the law; but what is reasonable compensation for its officers is primarily for the stockholders.[145]

Court battles over executive compensation dwindled at decade's end.[146] Executive pay would not again become an issue for the courts until the late 1940s when a new round of litiga-

technically authorized, thus providing at least one check on careless compensation procedures. *See* Winkelman v. Gen. Motors Corp., 39 F. Supp. 826, 835 (S.D.N.Y. 1940); Gallin v. Nat'l City Bank, 281 N.Y.S. 795, 807 (N.Y. Sup. Ct. 1935) (referee's report); Gallin v. Nat'l City Bank, 273 N.Y.S. 87, 119–20 (N.Y. Sup. Ct. 1934) (appointing a referee to report on executive compensation).

141. *See, e.g.*, McQuillen v. Nat'l Cash Register Co., 27 F. Supp. 639, 651 (D. Md. 1939), *aff'd*, 112 F.2d 877 (4th Cir. 1940) ("It is not intended that the courts shall be called upon to make a yearly audit and adjust salaries." (quoting Seitz v. Union Brass & Metal Mfg. Co., 189 N.W. 586, 587–88 (Minn. 1922))); Heller v. Boylan, 29 N.Y.S.2d 653, 680 (N.Y. Sup. Ct. 1941) (holding that shareholders have the responsibility to determine what is reasonable "compensation for [their] officers"); *see also* Shorten, *supra* note 91, at 146 ("The determination that compensation is excessive or unreasonable is one that courts are ordinarily loath to make.").

142. *McQuillen*, 27 F. Supp. at 650–53.

143. *Id.* at 653.

144. *Id.*

145. *Heller*, 29 N.Y.S.2d at 680.

146. Wells, *supra* note 80, at 758.

tion was sparked not by public outrage but by changes in the tax code. During and after World War II, marginal tax rates were startlingly high; in 1950, the rate was eighty-nine percent for incomes above $100,000, rising to ninety-one percent for incomes above $200,000.[147] In 1950, however, the tax code was altered[148] to provide favorable treatment for restricted stock options.[149] Executives receiving stock options as compensation were allowed to delay recognizing income from receipt of options and to have the options taxed at a far lower capital gains rate, so long as they met certain requirements.[150] Understandably, this made stock options very popular.[151] Before 1950, options were rarely used in compensation packages; by 1961, most companies listed on the New York Stock Exchange included stock options in their executive compensation plans.[152]

As use of stock options increased, so did litigation over them. During the 1950s, the prevalent issue concerning executive compensation in the Delaware courts was the validity of

147. FEDERAL INDIVIDUAL INCOME TAX RATES HISTORY, 1913–2010, TAX FOUND. (Sept. 23, 2009), http://www.taxfoundation.org/files/fed_individual_rate_history-20100923.pdf (for married persons filing separately).

148. Revenue Act of 1950, Pub. L. No. 81-814, § 218, 64 Stat. 906, 942–44.

149. ROBERT CHARLES CLARK, CORPORATE LAW § 6.2.1, at 203 (1986). Stock options had long been allowed in corporate law. *See* JOHN C. BAKER, EXECUTIVE SALARIES AND BONUS PLANS 196–97 (1938); BERLE & MEANS, *supra* note 23, at 180–85. But these were little used in executive compensation plans until the tax changes made them favorable in 1950. *See* 2 GEORGE THOMAS WASHINGTON & HENRY V. ROTHSCHILD, 2ND, COMPENSATING THE CORPORATE EXECUTIVE 569 (3d ed. 1962).

150. CLARK, *supra* note 149, § 6.2.1, at 203. The most significant requirement being that they hold the options for at least two years before exercising them and hold the stock resulting from the exercise for at least six months. *See* § 218, 64 Stat. at 942.

151. 2 WASHINGTON & ROTHSCHILD, *supra* note 149, at 569; *see also* CLARK, *supra* note 149, § 6.2.1, at 203 ("[A] substantial majority of large public corporations adopted restricted stock option plans during the 1950s and 1960s.").

152. *See* 2 WASHINGTON & ROTHSCHILD, *supra* note 149, at 569 & n.3. Stock options' popularity continued to vary over the decades. When the tax code was changed in 1964 to remove some of their benefits, use of stock options declined. CLARK, *supra* note 149, § 6.2.1, at 203–04. When in the 1980s new emphasis was placed on compensation means that would link pay to performance, use of stock options again rose. Brian J. Hall, *What You Need to Know About Stock Options*, 78 HARV. BUS. REV. 121, 123–24 (2000). And use of stock options became still more prevalent when, in 1992, Congress changed the tax code to reduce the deductibility of non-performance-based compensation. *See* Ian Dew-Becker, *How Much Sunlight Does it Take to Disinfect a Boardroom? A Short History of Executive Compensation Regulation in America*, 55 CESIFO ECON. STUD. 434, 446–48 (2009).

corporate stock option grants.[153] In the stock options cases, shareholder-plaintiffs challenged option grants to executives by contending that options given as part of executive compensation plans were effectively given without consideration (i.e., in a completely one-sided transaction) and so constituted waste.[154] Delaware's courts were initially receptive to this argument, and in two 1952 decisions, the courts promised to provide substantive scrutiny of a method at the cutting edge of executive compensation.[155]

Corporations' power to grant options was not directly at issue,[156] as Delaware's courts had long upheld the validity of stock option grants.[157] The courts had also, though, recited a rule suggesting that review of such grants would demand more than simply that they do not constitute waste: if options were given for services, the services' "value must bear some reasonable relation to the value of the right given."[158] In 1952, the Delaware Supreme Court decided two major cases challenging the validity of corporations' executive stock option plans, *Gottlieb v. Heyden Chemical Corp.*[159] and *Kerbs v. California Eastern Air-*

153. Harry G. Henn, Book Review, 49 CORNELL L.Q. 574, 576 n.14 (1964).

154. The line of cases discussed here is reviewed in *Lewis v. Vogelstein*, 699 A.2d 327, 336–38 (Del. Ch. 1997), and also discussed in, among others, Charles M. Yablon, *Overcompensating: The Corporate Lawyer and Executive Pay*, 92 COLUM. L. REV. 1867, 1902–04 (1992) (reviewing CRYSTAL, *supra* note 112), and Shorten, *supra* note 91, at 146 n.86. For further discussion, see CLARK, *supra* note 149, § 6.2.2, at 213–17, explaining different court decisions regarding consideration, and 2 WASHINGTON & ROTHSCHILD, *supra* note 149, at 607–08, noting that "[e]ach individual to whom a stock option is granted shall, as consideration for the grant thereof, agree to remain in the employ of the Corporation."

155. *See* Gottlieb v. Heyden Chem. Corp., 90 A.2d 660, 664 (Del. 1952); Kerbs v. Cal. E. Airways, Inc., 90 A.2d 652, 656–58 (Del. 1952). Even observers at the time noted the oddity of Delaware's courts imposing heightened scrutiny of stock options. One wrote that in stock option litigation, the Delaware courts during the 1950s "demonstrated an un-Delaware-like approach." Henn, *supra* note 153, at 576 n.14.

156. They were specifically provided for in Delaware's corporation law in 1929, and allowed by the courts before then. *See* Grimes v. Alteon, Inc., 804 A.2d 256, 263–64 & n.16 (Del. 2002) (discussing the history of stock options in Delaware).

157. *See id.* at 263–64.

158. Rosenthal v. Burry Biscuit Corp., 60 A.2d 106, 109 (Del. Ch. 1948); *see also* Wyles v. Campbell, 77 F. Supp. 343, 346–47 (D. Del. 1948) ("[W]here corporate funds are applied to incentive or other compensation of corporate officers, such remuneration must bear a reasonable relation to the value of the services for which the funds are applied.").

159. 90 A.2d 660.

ways, Inc.[160] In each case, the corporation's board had approved an options grant for senior executives, and while some directors were recipients of the grants, in each case the corporation sought and received shareholder ratification.[161] Shareholder-plaintiffs subsequently challenged the grants at both firms on several grounds, including that the grants were given without receipt of consideration from the executives and so constituted waste.[162] In both cases, the court held that the shareholder ratification had served to give the directors a presumption that they acted in good faith.[163] Yet it was insufficient to extinguish the waste claim, as only a unanimous vote of shareholders could give away corporate assets.[164] The major difference between the two cases was their outcome. In *Gottlieb*, the Delaware Supreme Court denied summary judgment to defendants, holding that the chancery court should determine whether what was received by the corporation was sufficient to constitute legal consideration.[165] According to the court, the test was not whether the contracts recited consideration, but whether consideration was actually received; if it was, "it is a judicial responsibility to detect it and give it recognition."[166]

Kerbs made clear what this meant. The test it set down required a court to review the substance of a compensation award and not just the process followed in awarding it.[167] The validity of a stock option plan, the court held, "depends directly upon the existence of consideration to the corporation and the inclusion in the plan of conditions, or the existence of circumstances which may be expected to insure that the contemplated consideration will in fact pass to that corporation."[168] Under the *Kerbs* test, a variety of things could be sufficient consideration, including retention of an employee's services, but there needed to be "a reasonable relationship between the value of the services to be rendered by the employee and the value of the options granted as an inducement or compensation."[169] While the court refused to set down "a minimum set of prescribed requirements

160. 90 A.2d 652.
161. *See Gottlieb*, 90 A.2d at 662–63; *Kerbs*, 90 A.2d at 655–56.
162. *See Gottlieb*, 90 A.2d at 662; *Kerbs*, 90 A.2d at 655–56.
163. *See Gottlieb*, 90 A.2d. at 663–64; *Kerbs*, 90 A.2d at 655, 659.
164. *Gottlieb*, 90 A.2d at 663–64; *Kerbs*, 90 A.2d at 656–57 & n.2.
165. *Gottlieb*, 90 A.2d at 664.
166. *Id.*
167. *Kerbs*, 90 A.2d at 656–57.
168. *Id.* at 656 (citations omitted).
169. *Id.* (citations omitted).

that must be contained in every compensation stock option plan,"[170] it stated that "there must be some circumstance which may reasonably be regarded as sufficient to insure that the corporation will receive that which it desires to obtain by granting the option."[171] California Eastern Airways' plan, the court held, did not meet this test.[172] The options were granted to employees as inducement to keep them in the firm's employ, but the employees could immediately exercise all the options either while employed at the airways or within six months of leaving the firm.[173] Because the options grant did not ensure that the airline would "receive that which it desire[d] to obtain by granting the option," (i.e., the employee's continued service), the options were invalid as waste.[174]

At the moment when stock options were becoming vital to executive compensation plans—were "the vogue," as the *Kerbs* court put it[175]—the Delaware Supreme Court imposed a heightened level of scrutiny on their use. *Kerbs* set out a two-part test, asking (1) whether there was a reasonable relationship between the options and consideration, and (2) whether the circumstances were sufficient to ensure that the corporation actually received the benefit sought.[176] Although the court invoked the waste standard, this test was, as Chancellor Allen later noted, "rather distant from the substance of a waste standard of review[,] . . . seem[ing] to be a form of heightened scrutiny that is now sometimes referred to as an intermediate or proportionality review."[177]

Yet soon enough Delaware's courts would retreat from imposing heightened scrutiny on executive compensation plans. True, the rules set down in the 1952 cases remained good law for the rest of the decade.[178] But in 1953, Delaware's legislature amended its corporation law in response to dicta in the cases to make clear that the board's judgment concerning consideration

170. *Id.* at 657–58.
171. *Id.* at 657.
172. *Id.* at 657–58.
173. *Id.*
174. *Id.*
175. *Id.* at 656.
176. *Id.*; *see also* Lewis v. Vogelstein, 699 A.2d 327, 337 (Del. Ch. 1997).
177. *Lewis*, 699 A.2d at 337.
178. *Cf.* EDWARD P. WELCH ET AL., 1 FOLK ON THE DELAWARE GENERAL CORPORATION LAW § 157.3.2 (5th ed. 2010) (explaining that since the decision in *Beard v. Elster*, 160 A.2d 731 (Del. 1960), "the attitude of the Delaware courts toward stock options has become quite lenient").

for options would be conclusive "absent fraud."[179] More significantly, in 1960 the state's supreme court backed away from *Kerbs* and *Gottlieb* in *Beard v. Elster*, a challenge to American Airlines's employee stock option plan.[180] While the earlier cases had set out a two-part test, *Beard* limited the earlier holding in two ways. First, it held that the earlier cases should not have been taken to require some legally cognizable consideration (i.e., "a measurable quid pro quo").[181] Second, it limited the sharp rule announced in *Kerbs* to cases where stock options had been granted by self-interested boards.[182] For situations where approval was given by a disinterested board or committee, the *Beard* court established a different rule, one that hewed more closely to Delaware's traditional approach to other kinds of executive compensation. In *Beard*, the majority of the board approving the stock option plan had been disinterested, and the plan had also received stockholder ratification.[183] In such a situation, the supreme court concluded that a court should not apply the two-prong test established in *Kerbs*.[184] Instead, a court should apply the highly deferential business judgment rule, under which a court is "precluded from substituting [its] uninformed opinion for that of experienced business managers . . . who have no personal interest in the outcome."[185]

The court's point was clear enough. Judges lacked the capacity to evaluate executive compensation, have at best "uninformed opinion[s]," and should normally defer to those "experienced business managers" who had actual knowledge of the matter.[186] After *Beard*, Delaware courts' review of executive options grants would shift back from substantive-based to process-based scrutiny, focusing "in practice less on attempting independently to assess whether the corporation in fact would receive proportional value, and more on the procedures used to authorize . . . such grants."[187] While courts still sometimes assert that "there must be a reasonable relationship between the

179. 2 WASHINGTON & ROTHSCHILD, *supra* note 149, at 578–79 & n.43. Previously the statute had only covered consideration for stock. WELCH ET AL., *supra* note 178, § 157.3.2.

180. *Beard*, 160 A.2d 731.

181. *Id.* at 736.

182. *Id.* at 736–37.

183. *Id.*

184. *See id.* at 737–39.

185. *Id.*

186. *See id.*

187. Lewis v. Vogelstein, 699 A.2d 327, 338 (Del. Ch. 1997).

value of the benefits passing to the corporation and the value of the options granted,"[188] they would in fact apply the waste test.[189] Thus, judicial intervention was warranted only in the extreme cases where there was no consideration at all[190] or, much the same thing, when no reasonable business person could have entered into the challenged exchange.[191] By 1990, one scholar could write that in Delaware "the business judgment rule protects almost any compensation decision made by a disinterested committee of the board."[192] In 1997, *Lewis v. Vogelstein* made explicit what had occurred long before by abandoning the line of cases that suggested that stock options grants required a review of "proportionality" rather than merely the waste test.[193]

The 1990s could be seen from one perspective as a low point for judicial scrutiny of executive compensation. Notably, a number of Delaware judges began urging the abandonment of the waste doctrine, which had long been used as a final, albeit usually unsuccessful, claim against truly egregious compensa-

188. Pogostin v. Rice, 480 A.2d 619, 625 (Del. 1984), *overruled on other grounds by* Brehm v. Eisner, 746 A.2d 244, 254 (Del. 2000) (holding that "review of decisions of the Court of Chancery applying Rule 23.1 is *de novo* and plenary," rather than "deferential, limited to a determination of whether the Court of Chancery abused its discretion").

189. *See Pogostin*, 480 A.2d at 626 (holding that the plaintiffs did not meet the "burden of demonstrating by particularized allegations that the Plan itself is so devoid of a legitimate corporate purpose as to be a waste of assets").

190. *Cf.* Michelson v. Duncan, 407 A.2d 211, 223 (Del. 1979) (citing *Gottlieb* with regard to waste); *see also Lewis*, 699 A.2d at 337–38 (discussing the erosion of the test set out in *Kerbs* and *Gottlieb*).

191. *See Lewis*, 699 A.2d at 336. Though these tests seem to differ, in practice they asked much the same thing, and Chancellor Allen effectively equated them in *Lewis*. *See id.*

192. Yablon, *supra* note 154, at 1904.

193. *Lewis*, 699 A.2d at 336. *Lewis* also illustrates the degree to which Delaware's judiciary can, perhaps inadvertently, rewrite its own history. In *Lewis*, the Chancellor paints the stock option cases as historical curiosities, and links them to early twentieth century worries about director compensation and stock watering. *See id.* The two cases that he cites discussing this both date from the early 1920s. *Id.* at 336 nn.15–16 (citing Cahall v. Lofland, 114 A.2d 224 (Del. Ch. 1922); Scully v. Auto. Fin. Corp., 109 A.2d 49 (Del. Ch. 1920)). But the stock options cases were not lingering remnants of the 1920s; rather, they were handed down in a period when stock options were becoming a favored method of executive compensation, something *Kerbs* directly notes. Kerbs v. Cal. E. Airways, Inc., 90 A.2d 652, 656 (Del. 1952). The discussion in *Lewis* thus downplays the degree to which, in the stock options cases, Delaware's courts chose to apply a higher level of scrutiny to a prevalent method of executive compensation.

tion.[194] In one 1995 opinion, Chancellor Allen denigrated waste claims as a "theoretical exception" to the general rule that a court "will not review the substance of [a] corporate contract" absent fraud or self-dealing, and wrote that the likelihood of the existence of a case that would "meet the legal standard of waste" was about as likely as the existence of the Loch Ness Monster.[195] In 1999, Vice Chancellor Strine was even more blunt, describing waste as a "vestige" of discarded doctrines and urging that the law be changed to allow a majority shareholder vote to extinguish a waste claim.[196]

Executive compensation did not, however, disappear from the courts. While the 1990s saw judicial criticism of the waste standard, outside the courtroom executive compensation remained a contentious issue as executives' pay continued to outpace that of workers.[197] It was in this environment that the Delaware courts made another, more tentative foray into executive compensation in the *Disney* decisions of the early 2000s.[198] *Disney* seemed for a time to open up a new avenue for challenges to executive compensation: directors' duty of good faith, a longstanding yet ill-defined element of directors' fiduciary duties.[199]

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194. Waste claims may generally be seen as "losers," but a study one of the authors performed found that, as of 2000, plaintiffs making waste claims in connection with executive compensation in the Delaware courts won about forty percent of the time, with a "win" defined as success at some stage of the litigation process. *See* Thomas & Martin, *supra* note 14, at 571–72. This percentage may make waste claims look more successful than they are, however, as Delaware courts are loathe to dismiss waste claims on summary judgment. *See id.* at 583 n.57.

195. Steiner v. Meyerson, No. 13139, 1995 WL 441999, at *5 (Del. Ch. July 19, 1995).

196. Harbor Fin. Partners v. Huizenga, 751 A.2d 879, 897 (Del. Ch. 1999).

197. MISHEL ET AL., *supra* note 113, at 220, 221 fig.3AE.

198. *In re* Walt Disney Co. Derivative Litig., 907 A.2d 693 (Del. Ch. 2005), *aff'd*, 906 A.2d 27 (Del. 2006); *In re* Walt Disney Co. Derivative Litig., 731 A.2d 342 (Del. Ch. 1998), *aff'd in part, rev'd in part sub nom.* Brehm v. Eisner, 746 A.2d 244 (Del. 2000).

199. *Disney* generated a significant literature on "good faith." *See generally* Christopher M. Bruner, *Good Faith, State of Mind, and the Outer Boundaries of Director Liability in Corporate Law*, 31 WAKE FOREST L. REV. 1131, 1131 (2006) ("The inability of Delaware's courts to identify what a corporate director's core fiduciary duties are, let alone what the scope of those duties might be, is one of the most pressing—and from a director's point of view, distressing—issues in corporate law today."); Sean J. Griffith, *Good Faith Business Judgment: A Theory of Rhetoric in Corporate Law Jurisprudence*, 55 DUKE L.J. 1, 4 (2005) ("The function of good faith in corporate law, however, is not perfectly clear."); Claire A. Hill & Brett McDonnell, *Disney, Good Faith, and Structural Bias*, 32 J. CORP. L. 833, 855–62 (2007) ("The court created space

The *Disney* cases grew out of the highly public hiring, and shortly thereafter firing, of Michael Ovitz as president of the Walt Disney Company.[200] Ovitz was generously compensated as Disney president, and when terminated after little more than a year at the firm he received a severance package worth almost $130 million.[201] Shareholders filed suit, alleging, among other things, that in Ovitz's hiring and termination the Disney board had violated their fiduciary duties and committed waste.[202] In 1998, the chancery court granted summary judgment for the defendants, holding that demand was not excused.[203] On appeal, the Delaware Supreme Court in 2000 affirmed in part, reversed in part, and remanded, which allowed plaintiffs to repeal without prejudice.[204] While the substance of the 2000 supreme court opinion was not especially favorable to plaintiffs—not even allowing them discovery—its rhetoric voiced concern over both the size of the payments to Ovitz and the processes followed by Disney's board.[205] According to the court, it was "potentially a very troubling case on the merits."[206] As the court explained:

> [T]he compensation and termination payout for Ovitz were exceedingly lucrative, compared to Ovitz's value to the Company; and . . . the processes of the boards of directors in dealing with the approval and termination of the Ovitz Employment Agreement were casual, if not sloppy and perfunctory. . . . [T]he sheer size of the payout to Ovitz, as

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for a doctrine of good faith, but it provided little guidance as to how that doctrine might work, even in cases like *Disney* itself."); Elizabeth A. Nowicki, *Not in Good Faith*, 60 SMU L. REV. 441, 441–43 (2007) (explaining the distinction between "bad faith" and "not in good faith"); Hillary A. Sale, *Delaware's Good Faith*, 89 CORNELL L. REV. 456, 482–94 (2004) (explaining the "definitions for the duty of good faith under Delaware law, and drawing some conclusion about how it might apply in future cases").

200. *See In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 75 (Del. 2006).

201. *Id.*

202. *Disney*, 731 A.2d at 353. The discussion here deals with the challenges relying on good faith, but it should be remembered that the plaintiffs also alleged waste.

203. *See id.* ("Demand . . . is not prerequisite to derivative action only if the particularized facts alleged in the complaint create a reasonable doubt that: (1) the directors are disinterested and independent; or (2) the challenged transaction was otherwise the product of a valid exercise of business judgment.").

204. *See* Brehm v. Eisner, 746 A.2d 244, 267 (Del. 2000) ("The portion of paragraph 1 that dismissed 'plaintiffs claims for breach of fiduciary duty and waste . . . for failure to make a demand under Court of Chancery Rule 23.1,' is reversed only to the extent that the dismissal ordered by the Court of Chancery was with prejudice." (alteration in original)).

205. *Id.*

206. *Id.* at 249.

> alleged, pushes the envelope of judicial respect for the business judgment of directors in making compensation decisions.[207]

The 2000 decision seemed to open the door for new judicial engagement with executive compensation. While *Disney* was on remand, there were additional indications that Delaware's judges were becoming more concerned about levels of executive pay.[208] In January 2003, Chief Justice Norman Veasey gained media attention when he warned, in a speech about the process for setting executive compensation, that directors who were insufficiently independent in making compensation decisions could have their behavior "treated . . . as a breach of the fiduciary duty of good faith."[209]

The chancery court generated still more attention in May 2003 when the court, on remand, denied the *Disney* defendants' motion for summary judgment in a stinging opinion.[210] Although careful to note that the facts discussed were taken from plaintiffs' pleadings and so accepted as true for purposes of summary judgment, the opinion still painted a picture of Disney's board as disengaged and dysfunctional.[211] The directors appeared to be under the thumb of CEO Michael Eisner and had neglected basic duties, such as having approved the Ovitz hiring and termination decisions without seeing a copy of his employment agreement or asking for expert assistance.[212] As the court summarized them:

> [T]he facts alleged in the new complaints suggest that the defendant directors *consciously and intentionally disregarded their responsibilities*, adopting a 'we don't care about the risks' attitude . . . . Put differently, all of the alleged facts, if true, imply that the director defendants *knew* that they were making material decisions without adequate information and without adequate deliberation, and they

207. *Id.*

208. Delaware's judges have increasingly made public comments about trends in corporation law, paralleling their tendency to issue "hortatory opinion[s]." Edward B. Rock & Michael L. Wachter, *Islands of Conscious Power: Law, Norms, and the Self-Governing Corporation*, 149 U. PA. L. REV. 1619, 1679–80 (2001).

209. Tom Becker, *Delaware Justice Warns Boards of Liability for Executive Pay*, WALL ST. J., Jan. 6, 2003, at A14.

210. *In re* Walt Disney Co. Derivative Litig., 825 A.2d 275, 277–78 (Del. Ch. 2003) ("Because the facts alleged here, if true, portray directors consciously indifferent to a material issue facing the corporation, the law must be strong enough to intervene against abuse of trust.").

211. *See id.* at 287–90.

212. *Id.* at 278, 281.

> simply did not care if the decisions caused the corporation and its stockholders to suffer injury or loss.[213]

While the exact implications were unclear, this passage could be read to mean that directors who knowingly acted without adequate information and deliberation in approving an executive compensation package had failed to satisfy their fiduciary duty to act in good faith. This was particularly significant because actions made not in good faith are not covered by one of the central protections provided directors by Delaware's corporate law, the exculpatory provision allowed in Delaware General Corporation Law (DGCL) section 102(b)(7) and included in Disney's charter.[214]

For all its harsh tone and worrisome implications, though, the decision's import was ambiguous. Did it signal, in the wake of continued rising executive pay and the post-Enron passage of the Sarbanes-Oxley Act,[215] that Delaware's courts were prepared to make more searching inquiry into executive compensation decisions, relying on "good faith" as a legal tool to second-guess noninterested decisions? Or was it merely the product of a better-drafted plaintiffs' complaint?[216] In 2003, many thought the former, and particularly feared that the court's discussion of lack of good faith by the board had created a new avenue for director liability.[217] News reports suggest as much, and (by then) former Chief Justice Veasey reinforced this view when he wrote in the *Business Lawyer* in 2004 criticizing the belief "that there is no limit to what executive compensation committees may do in fixing the compensation of CEOs and other senior managers," and cautioning that the process of setting executive compensation must "be genuine,

213. *Id.* at 289.

214. *See id.* at 286 (citation omitted).

215. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

216. *See* Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 643 & n.211 (2003) (noting in the immediate aftermath of the *Disney* case, "[t]he difficulty here is to sort out not so much whether Delaware shifted, but whether its abrupt shift was due primarily to the federal gravitational pull, to the dynamics of the litigation, or to the state's direct perception of the underlying corporate problems").

217. *See, e.g.*, Joseph E. Bachelder III, 'Disney'*: Spotlight on 'Good Faith' and Directors' Liabilities*, N.Y. L.J., Aug. 29, 2003, at 3 (stating that as a result of the case, "an erosion may take place not only in the scope of protection under §102(b)(7) [sic], but also in the traditionally assumed protection under the business judgment rule"); Patrick McGeehan, *Case Could Redefine Board Member Liability*, N.Y. TIMES, June 14, 2003, at C1, *available at* 2003 WLNR 5236283.

not a rote, 'check the box' exercise."[218] Yet, later decisions in the *Disney* case did not impose on board compensation decisions the increased scrutiny some thought the Delaware courts promised in 2003.[219] In 2005, after a trial on the merits, the chancery court found that the *Disney* defendants had not "breach[ed] their fiduciary duties or commit[ted] waste,"[220] a decision upheld a year later by the Delaware Supreme Court.[221] Both of the later decisions were sharply critical of the directors' decisions and methods and depicted Disney's 1990s decisionmaking processes as falling short of best practices, but neither decision found that the Disney directors' actions violated their legal duties.[222] Nor would good faith prove to be an easy tool for increased scrutiny of board decisionmaking or a means to challenge even egregiously negligent decisionmaking.[223] After *Disney*, the Delaware Supreme Court held that good faith was neither a freestanding fiduciary duty, nor an element of the duty

218. E. Norman Veasey, *Counseling Directors in the New Corporate Culture*, 59 BUS. LAW. 1447, 1451 (2004).

219. Others have speculated that, following the collapse of the dot-com bubble and Enron Corporation in 2000, Delaware's courts briefly took a less deferential approach as a response to possible federal corporate regulation, and as that threat retreated, returned to traditional, deferential approaches. *See, e.g.*, Timothy P. Glynn, *Delaware's VantagePoint: The Empire Strikes Back in the Post-Post Enron Era*, 102 NW. U. L. REV. 91, 102–04 (2008) (summarizing the claim that Delaware courts briefly became less management friendly post-Enron).

220. *In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 697 (Del. Ch. 2005), *aff'd*, 906 A.2d 27 (Del. 2006).

221. *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 75 (Del. 2006).

222. *See id.* at 68 ("Without such a duty to act, the new board's failure to vote on the termination could not give rise to a breach of the duty of care or the duty to act in good faith."); *Disney*, 907 A.2d at 776 ("Because the board was under no duty to act, they did not violate their fiduciary duty of care, and they also individually acted in good faith."). As others have noted, discussions of "best practices" in Delaware decisions may well influence the behavior of other corporate actors—they are not just pious verbiage—but they do not impose legal liability on directors for breach of their duties or for waste. *See* Claire Hill & Brett McDonnell, *Executive Compensation and the Optimal Penumbra of Delaware Corporation Law*, 4 VA. L. & BUS. REV. 333, 362 (2009) (discussing why directors abide by a legal "penumbra" rather than what is required by law); Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009, 1016–17 (1997) (discussing how the rhetorical approaches of the judiciary and corporate counsel in Delaware create legal norms).

223. *See Disney*, 906 A.2d at 63 (stating that plaintiffs' "verbal effort to collapse the duty to act in good faith into the duty to act with due care, is not unlike putting a rabbit into the proverbial hat and then blaming the trial judge for making the insertion").

of care, but an aspect of the duty of loyalty.[224] The court emphasized that a violation of the duty of good faith required some form of deliberate or conscious choice—an intentional abdication of a directorial obligation.[225] Mere procedural defects or directorial inattention do not rise to the level of bad faith necessary to overcome the business judgment rule, and thus would not afford courts an opening to police more closely executive compensation.[226]

The 1930s compensation cases, the stock option cases, and the *Disney* decisions all indicate that courts, even Delaware's allegedly promanagement courts,[227] have at times been willing to impose or at least threaten higher scrutiny for executive compensation. By itself, this account could leave the impression that such higher scrutiny of compensation awards is episodic, with more rigorous review coming to the fore at moments of stress in the economic system (e.g., the Great Depression or the post-Enron period) only to be followed by the return to a deferential stance as public dissatisfaction subsides.

Some evidence, however, suggests otherwise. One of the authors has conducted an empirical study of cases in which shareholders challenged compensation pay levels and practices at public and close corporations.[228] The study identified 124 reported cases in the period from 1912 to 2000 in which a "court decided an issue about the process, size, or composition of an executive's pay."[229] It found that in a significant percentage of those cases, shareholders were successful at some stage of the

224. *See* Stone *ex rel.* AmSouth Bancorporation v. Ritter, 911 A.2d 362, 369–70 (Del. 2006).

225. *Id.* at 370; *see also* Leo E. Strine, Jr. et al., *Loyalty's Core Demand: The Defining Role of Good Faith in Corporation La*w, 98 GEO. L.J. 629, 688–90 (2010) (discussing the course of the Delaware Supreme Court from *Disney* to its holding in *Stone* that one cannot negligently act in bad faith).

226. *See Stone*, 911 A.2d at 369 ("[O]nly a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition to liability." (quoting *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 971 (Del. Ch. 1996))).

227. The debate over whether Delaware's courts and corporation law are more promanagement than other states' is interminable. *See, e.g.*, Glynn, *supra* note 219, at 93 (discussing Delaware's highly deferential approach to corporate decisionmaking).

228. Thomas & Martin, *supra* note 14, at 571.

229. *Id.* at 571, 573. For limitations on the study, see *id.* at 574–75.

litigation process.[230] To be sure, plaintiffs had lower rates of success in Delaware's courts than those of other states,[231] and lower rates of success when challenging compensation at public corporations as opposed to closely held ones.[232] Yet, even plaintiffs in what should have been an unfriendly situation—challenging compensation at a public corporation in a Delaware court—enjoyed some measure of success.[233]

Contrary to the received wisdom, then, courts have not been uniformly hostile to challenges to executive compensation. From time to time, courts have applied heightened scrutiny to either the process or substance of executive compensation decisions, and across the years plaintiffs have enjoyed some success challenging executive compensation decisions in the courts. Courts, however, have been reluctant to engage in ongoing monitoring of executive compensation, voicing the belief (as they did in the 1930s and 1950s) that they were ill equipped to set executive compensation or second-guess the considered judgments of boards of directors.[234] They have been hampered, at least in part, by the waste doctrine and its inherent weaknesses, and by lack of any alternative, practicable approach to scrutinizing compensation.

In the following Parts we examine a new development in Delaware jurisprudence, the recognition of officers' fiduciary duties, which can empower courts to scrutinize more closely executive compensation decisions without thrusting onto judges the role of pay setter that they wish to avoid. This approach fits well with the state's existing corporate jurisprudence while also directly addressing the underlying claims of Board Capture theory.

IV. THE EMERGENCE OF OFFICERS' FIDUCIARY DUTIES

A new avenue for challenges to executive compensation has been opened by an important recent development in Delaware law. In *Gantler v. Stephens*,[235] the Delaware Supreme Court

230. *Id.* at 571 (defining "success" as a victory at one stage of the litigation process, such as a motion to dismiss, a motion for summary judgment, trial, or appeal).

231. *Id.* at 587.

232. *Id.* at 601.

233. *Id.* at 611 (noting that plaintiffs succeeded at some stage of the litigation in twelve out of thirty-five cases).

234. *Id.* at 601–02.

235. 965 A.2d 695 (Del. 2009).

held that officers of Delaware corporations owe the same fiduciary duties of care and loyalty to the corporation and its shareholders as do directors.[236] In *Gantler*, shareholders of a bank holding company sued several of its directors as well as a nondirector officer, alleging, among other things, that the defendants violated their fiduciary duties by self-servingly sabotaging an opportunity to sell the company.[237] The supreme court's decision held, as observers had long presumed, that "the fiduciary duties of officers are the same as those of directors."[238]

While *Gantler* explicitly answered the question of what officers' fiduciary duties to the corporation and shareholders were, it left open at least two other important questions. First, why had such a vital issue taken so long to come before the court? Second, what are the contours of officers' fiduciary duties? As to the first question, the Delaware courts' neglect was of a piece with the general neglect of officers' duties.[239] Few cases over the years in any jurisdiction addressed whether officers owed their corporation fiduciary duties,[240] few scholars

236. *Id.* at 708–09.

237. *See id.* at 699–703.

238. *Id.* at 709. The supreme court appeared to be a latecomer to this conclusion. Earlier decisions by the chancery court presumed that officers' duties were the same as directors'. *See* Ryan v. Gifford, 935 A.2d 258, 269 (Del. Ch. 2007); *In re* Walt Disney Derivative Litig., No. Civ.A. 15452, 2004 WL 2050138, at *3 & nn.32 & 38 (Del. Ch. Sept. 10, 2004). Scholars, too, had generally assumed this for both Delaware and other jurisdictions. *See* CLARK, *supra* note 149, § 45, at 123 ("Statutes and case law say that directors and officers owe their corporations a duty of care."); COX & HAZEN, *supra* note 3, § 10.01, at 184 (the duty of care "can be seen as embracing a standard for officer and director conduct"); 1 DAVID A. DREXLER ET AL., DELAWARE CORPORATION LAW AND PRACTICE § 14.02, at 14-5 (2009) (noting that because officers' and directors' duties are the same, "there is no need for a separate discussion of the fiduciary responsibilities of corporate officers"); Lyman P.Q. Johnson & David Millon, *Recalling Why Corporate Officers Are Fiduciaries*, 46 WM. & MARY L. REV. 1597, 1600 & n.10 (2005) ("[C]ourts and commentators routinely describe the duties of directors and officers together, and in identical terms."); Sparks & Hamermesh, *supra* note 16, at 217 ("Many courts and commentators have taken the position that the rights, duties and liabilities of corporate officers and directors vis-a-vis the corporation and its stockholders are coextensive."). The assumption also appears in the case law of other states. *See id.* at 217.

239. *See* Lyman Johnson & Dennis Garvis, *Are Corporate Officers Advised About Fiduciary Duties?*, 64 BUS. LAW. 1105, 1106 (2009); Sparks & Hamermesh, *supra* note 16, at 215.

240. *But see* Sparks & Hamermesh, *supra* note 16, at 217 nn.13–17 (citing cases in which the court ruled that specific officers had fiduciary duties, such as the president, attorneys, secretaries, vice presidents, and chief executive officers).

examined the question,[241] and when either spoke on the issue it was usually to make the cursory statement that "directors and officers" owed the corporation fiduciary duties.[242] Directors' fiduciary duties received voluminous attention, but officers' duties did not. It is a strange omission considering that, during much of the last century, students of the corporation were repeatedly advancing some version of the Board Capture hypothesis and arguing that, even though boards of directors had legal power to manage the corporation, the CEO usually wielded the real power.[243] Why, then, was not the law of officers' fiduciary duties being developed by a series of lawsuits against officers *qua* officers? Why, if real power was held by officers, were fiduciary duty suits being filed against directors instead?

Scholars have offered a series of explanations for this neglect, including the ability of a board to discipline a negligent or disloyal officer through contractual means or intracorporate sanctions, the lack of a comparable mechanism to discipline directors,[244] and the fact that directors retained, under the law, the ultimate power to fire managers.[245] We do not disagree with any of these, but would highlight one other reason why directors' duties were developed and officers' were not. Until well into the 1980s, the CEO and other senior officers were usually directors, and many boards were populated largely by inside director-officers.[246] Even though the roles of director and officer were legally distinct, in practice they were combined in these

241. Although, in recent years there has been an upsurge of studies touching on officers' fiduciary duties. *See, e.g.*, Z. Jill Barclift, *Senior Corporate Officers and the Duty of Candor: Do the CEO and CFO Have a Duty to Inform?*, 41 VAL. U. L. REV. 269 (2006); Shannon German, *What They Don't Know Can Hurt Them: Corporate Officers' Duty of Candor to Directors*, 34 DEL. J. CORP. L. 221 (2009); Lawrence A. Hamermesh & A. Gilchrist Sparks III, *Corporate Officers and the Business Judgment Rule: A Reply to Professor Johnson*, 60 BUS. LAW. 865 (2005); David A. Hoffman, *Self-Handicapping and Managers' Duty of Care*, 42 WAKE FOREST L. REV. 803 (2007); Lyman P.Q. Johnson, *Corporate Officers and the Business Judgment Rule*, 60 BUS. LAW. 439 (2005); Johnson & Garvis, *supra* note 239; Johnson & Millon, *supra* note 238; Langevoort, *supra* note 16; Usha Rodrigues, *From Loyalty to Conflict: Addressing Fiduciary Duty at the Officer Level*, 61 FLA. L. REV. 1 (2009); Sale, *supra* note 199.

242. *See* MARK A. SARGENT & DENNIS R. HONABACH, D & O LIABILITY HANDBOOK § I.10, at 45 (2009).

243. *See supra* Part II.

244. *See* Johnson & Millon, *supra* note 238, at 1611–14.

245. *See* Hoffman, *supra* note 241, at 808.

246. *See* Johnson & Millon, *supra* note 238, at 1612 n.59.

director-officers.[247] A lawsuit against a board for violation of fiduciary duties would thus in almost every instance also sweep up the firm's top officers, obviating the need to develop a separate theory of officer liability for violation of fiduciary duties.

The decline of the inside board of directors starting in the 1970s and its supersession by a monitoring board composed largely of independent directors may have sharpened awareness of the separate roles and distinct duties of senior officers.[248] Passage of various corporate reforms during 2002 that encouraged or mandated more independent directors, most notably the Sarbanes-Oxley Act, accelerated the trend.[249] Delaware's legislature acknowledged the increased salience of nondirector officers in 2003 when it amended its law to give the chancery court new jurisdiction over corporate officers, adding section 3114(b) to its law to give the court "personal jurisdiction over officers as such."[250] The official explanation of the new provision reflected this:

> Because of enhanced requirements for independent director representation on public company boards of directors, it is likely that fewer senior officers will also serve as directors. Therefore, had [s]ection 3114 not been amended, the ability to obtain personal jurisdiction in Delaware over some of the most significant participants in corporate governance would have been impaired.[251]

Ironically, the attempt to decrease officer power by, for example, raising the number of independent directors on boards and lowering the number of director-officers served to increase

247. *See* DEL. CODE ANN. tit. 8, §§ 141–142 (2001).

248. *See* Johnson & Millon, *supra* note 238, at 1620–22.

249. *Cf.* William B. Chandler III & Leo E. Strine, Jr., *The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State*, 152 U. PA. L. REV. 953, 1002–03 (2003) (noting the general effect of such corporate reforms).

250. *See* Johnson & Millon, *supra* note 238, at 1612–13 & n.61 (citation omitted).

251. SARGENT & HONABACH, *supra* note 242, § I.10, at 48 (quoting Del. Div. of Corp., *General Assembly Approves 2003 Amendments to Corporate Law*, ST. DEL. (June 30, 2003), http://www.state.de.us/corp/2003amends.shtml (discussing the 2003 Delaware law amendments)). Also important in the adoption of this section was an article by Professors Thompson and Sale, arguing for the increased importance of officer misconduct. *See* Chandler & Strine, *supra* note 249, at 1004 n.125 ("Delaware's intense focus on director accountability is inadequate to address the important issue of officer misconduct and has ceded core state law concerns to the federal government, which regulates officer conduct through disclosure regulation, some aspects of which have the intended effect of encouraging care and loyalty by officers." (citing Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections upon Federalism*, 56 VAND. L. REV. 859, 868–72 (2002))).

the attention paid to officers' duties, culminating (for the moment) in *Gantler*.

Gantler was a case of first impression and left open a number of questions relating to officers' fiduciary duties. For example, will assertions that officers violated their fiduciary duties to a corporation and its shareholders be treated identically to a similar allegation against directors? Are there any differences between how an officer's duties will be viewed compared to those of a director? There clearly will be some differences in application. Most obviously, an officer accused of violating his or her duty of care will lack the ironclad protection offered directors by the exculpatory provision of DGCL section 102(b)(7),[252] though we expect that officers will be able to invoke some of the protective rules now available to directors, notably the business judgment rule, when their decisions are challenged.[253] For purposes of this Article, however, we need not address all these questions. *Gantler* has answered the essential question concerning officers' duties. As we shall show below, the chancery court earlier had suggested how an officer's fiduciary duties should be applied in one important situation—when the officer is negotiating with the board for an employment contract.

V. OFFICERS' FIDUCIARY DUTIES AND EXECUTIVE COMPENSATION CONTRACTS

Gantler held that officers have "fiduciary duties of care and loyalty . . . [which] are the same as those of directors."[254] In so doing, it—perhaps unexpectedly—opened the door for the chan-

252. *See* Gantler v. Stephens, 965 A.2d 695, 709 n.37 (Del. 2009). This assumes that Delaware's legislature will not amend section 102(b)(7) to shield officers as well, something that may very well occur. *See* Michael Follett, Note, Gantler v. Stephens*: Big Epiphany or Big Failure?*, 35 DEL. J. CORP. L. 563, 576–77 (2010) (discussing application of section 102(b)(7) to officers).

253. *See* Gantler v. Stephens, No. 2392-VCP, 2008 WL 401124, at *8 (Del. Ch. Feb. 14, 2008), *rev'd on other grounds*, 965 A.2d 695 (holding that officers and directors are protected by the business judgment rule). *But see* Johnson, *supra* note 241, at 469 (arguing against automatic application of the business judgment rule to officers' decisions).

254. *Gantler*, 965 A.2d at 709; *see also id.* at 709 n.37 (noting the absence of section 102(b)(7) protections for officers). We note that the court's holding that officers' and directors' duties are "identical" appears to reject earlier proposals that "the fiduciary duties and liability rules for officers . . . be analyzed separately from those for outside directors," and that officers instead be found to be bound by a stronger set of fiduciary duties derived from agency law. Johnson & Millon, *supra* note 238, at 1604.

cery court to vigorously police executive compensation by allowing its judges to ask whether officers upheld their fiduciary duties when negotiating their compensation agreements. Indeed, the chancery court had already begun to develop such an approach.

Chancellor Chandler and Vice Chancellor Noble laid the basis for a new judicial approach to executive compensation in two important opinions that predated *Gantler*: (1) the 2003 *Disney* decision, which denied the defendant's summary judgment motion,[255] and (2) *Elkins*, a 2004 case in which shareholder-plaintiffs alleged, among other things, that a CEO violated his duty of loyalty when negotiating his compensation agreements with his corporation.[256] Read together, *Disney* and *Elkins* point toward a new way for courts to police excessive executive compensation, one that asks courts to scrutinize the processes by which an officer negotiated her compensation package.[257] The compensation package will be upheld if the officer did not, in the course of negotiating the pay package, breach her fiduciary duties.[258]

Under this approach, a preliminary step is to determine whether the individual negotiating the employment agreement is an officer of the company, or merely a prospective one. In both decisions, the Chancellor and Vice Chancellor differentiate between negotiations of initial employment contracts and subsequent employment contracts. In initial employment contracts, where a candidate has been offered a position as an executive at a company, but has not yet accepted, the candidate does not have a fiduciary obligation to the company.[259] Therefore, when the candidate is negotiating his or her initial employment contract with the company, he or she is free to bargain to obtain the most lucrative terms possible.[260] For example, in *Disney* one of the plaintiffs' allegations was that Michael Ovitz took advantage of his relationship with Disney CEO Michael Eisner to get himself an extremely favorable ini-

255. *In re* Walt Disney Co. Derivative Litig., 825 A.2d 275, 290 (Del. Ch. 2003).

256. Official Comm. of Unsecured Creditors of Integrated Health Servs., Inc. v. Elkins, No. Civ.A. 20228-NC, 2004 WL 1949290, at *16 (Del. Ch. Aug. 24, 2004).

257. *See id.* (citing *Disney*, 825 A.2d at 290).

258. *See id.* (citing *Disney*, 825 A.2d at 290).

259. *Id.*; *Disney*, 825 A.2d at 290.

260. *Elkins*, 2004 WL 1949290, at *16; *Disney*, 825 A.2d at 290.

tial employment agreement.[261] As the Chancellor noted, Ovitz was not a fiduciary of the company at the time that he negotiated this contract, and therefore the court would not apply any type of exacting judicial scrutiny to those negotiations.[262]

Once an executive enters into a firm's employment and becomes an officer of the company, however, things change.[263] She acquires fiduciary obligations to both the company and its shareholders.[264] These obligations prohibit her from using all the tools at her disposal to wring the most favorable compensation package possible from the company.[265] As the Chancellor and Vice Chancellor make clear in *Disney* and *Elkins*, her fiduciary obligations thereafter require her to negotiate any subsequent compensation agreement in a manner that is fair to the company from a procedural perspective—she must negotiate "*in an adversarial and arm's-length manner*."[266] In this potentially self-dealing transaction, the officer may not use tactics that would be unfair to the company.[267] For example, as the plaintiffs alleged in *Disney*, an officer negotiating a subsequent compensation agreement would be violating her fiduciary duties if she used the fact that she was a friend of the CEO, or secretary of the compensation committee, to receive special treatment.[268]

Within these broad parameters, there lurk a number of significant interpretive issues. For instance, what does it mean to say that a contract has been negotiated in an adversarial and arm's-length manner? One would think that such negotiations would be similar to those engaged in by two individuals who had no preexisting relationship. Thus, the prototypical ne-

261. *Disney*, 825 A.2d at 290.

262. *Id.*

263. *See id.* (noting that an officer does not owe fiduciary duties before becoming an officer).

264. *Id.*

265. *Id.*

266. *Id.* That the contract be equivalent to what would be reached in arm's-length negotiations may be a little much to ask, for this seems to be demanding that the contract be "perfect" in a way not possible in a world with transaction costs, and where some managers will inevitably wield some power in some negotiations. *See* Core et al., *supra* note 6, at 1161–63. For purposes of this Article, though, we recognize that the court is demanding, at minimum, that a negotiation process occur that is not deformed by illegitimate use of executive power and in which the parties attempt in good faith to replicate the agreement that an arm's-length, adversarial negotiation would produce.

267. *See Disney*, 825 A.2d at 290.

268. *See id.*

gotiation for a subsequent executive employment contract (i.e., a negotiation between the officer-fiduciary and the corporation) might look something like this: the executive, either on her behalf or represented by counsel, negotiates with a fully informed and vigorous chair or legal counsel of the compensation committee,[269] where the company's negotiator had no prior economic relationship or other disabling conflict of interest with the executive. One hallmark of arm's-length negotiations might be for the compensation committee to treat the negotiations with the CEO like those they engage in with lower-ranked officers of the company. For example, the committee might ask if the CEO has an offer, or the ability to get an offer, to leave the company for another position, or they might consider the level of compensation increases requested by the CEO in light of the increases granted to other officers at the firm. We might also expect the compensation committee to retain a respected negotiating agent whose task is to drive the best bargain possible for the company and who is not dependent on management for retention or compensation level.

As part of her fiduciary duties, the officer would also have an obligation to ensure that all material information concerning the agreement was disclosed to the board of directors before the execution of the contract.[270] For example, the officer would need to make sure that the compensation committee was fully informed as to any business dealings that the executive had with the primary negotiator for the company or any other types of information that would indicate that the negotiation process had been undermined.[271] In addition, the members of the compensation committee or the board itself would need to have the

269. The Chairman would need information about the prevailing market levels of compensation for similarly situated executives at comparable firms. This could require the compensation committee to retain a compensation consultant that did not have any conflicts of interest. Given the soon-to-be effective SEC rules mandating that companies disclose to their shareholders all work that their compensation consultants perform for the firm and what fees they receive for it, many public companies are already moving toward using specialized consultants for their executive compensation information. *See* Joann S. Lublin, *Boards Turn to Smaller Pay Advisors to Avoid Conflicts*, WALL ST. J., Jan. 11, 2010, at B7.

270. Such a disclosure could also be dictated by the officer's duty to disclose to the board matters calling for board oversight. *See* Sparks & Hamermesh, *supra* note 16, at 226.

271. *Cf. Disney*, 825 A.2d at 290 (noting that Ovitz and Eisner had a duty of good faith to negotiate with a compensation committee or at least keep the committee informed of their negotiations).

opportunity to examine the negotiation process and to question the terms of any contract that was negotiated.[272] During such a process, board members would need to have the opportunity to object to certain aspects of the negotiation or to provisions within the proposed employment contract.[273]

In *Elkins*, Vice Chancellor Noble gave some examples of the type of allegations that a plaintiff would need to make in order to successfully establish a prima facie case that an officer had breached his fiduciary duties in negotiating a subsequent employment contract.[274] There, Elkins, the CEO of a company, was heavily involved in both the compensation committee meetings and board meetings at which his contract was approved.[275] The plaintiffs alleged that Elkins had provided agendas for these meetings, attended them, spoken with directors about his compensation outside of the meetings, negotiated his compensation packages with the board and the compensation committee, and spoken with the board's compensation consultant.[276] The complaint further alleged that Elkins had reviewed the compensation consultant's reports before they were submitted to the board, had exerted pressure on the compensation consultant to justify Elkins's compensation, and had personally stated several inaccurate facts to the board.[277] Vice Chancellor Noble wrote that, while these allegations were not sufficient by themselves individually to show a breach of the duty of loyalty, together they suggested that Elkins might have engaged in a self-interested transaction.[278]

The *Elkins* decision suggests something else as well. While *Gantler* established that corporate officers have fiduciary duties identical to those of directors, not all corporate officers will have the opportunity to undermine their compensation negotiations. Thus, while the requirements for fair compensation nego-

272. *Cf. id.* at 291 (noting that Ovitz did not go to the Disney board and inform it of his decision to seek a departure, but instead negotiated with Eisner to develop a strategy that would allow Ovitz to receive the maximum benefit possible from his contract).

273. *Cf. id.* at 290 (remarking that the employment agreement between Eisner and Ovitz differed significantly from the draft summarized to the compensation committee).

274. *See* Official Comm. of Unsecured Creditors of Integrated Health Servs., Inc. v. Elkins, No. Civ.A. 20228-NC, 2004 WL 1949290, at *16 (Del. Ch. Aug. 24, 2004).

275. *Id.*

276. *Id.*

277. *Id.*

278. *Id.*

tiations set out in *Disney* and *Elkins* will apply to all officers, they will be particularly important for those top officers who will have the greatest opportunity and power to corrupt the negotiations process, most notably the CEO. Indeed, it would be the rare situation in which an officer other than the CEO was able to capture the negotiation process for her own employment agreement.

If it came to litigation, the shareholder-plaintiffs would be filing a derivative suit against the officers on behalf of the corporation and would need to satisfy the demand requirement.[279] This would not be all to the bad; the demand requirement functions to filter out meritless suits, and we expect that it would similarly function here to deter "strike suits" challenging most executive compensation decisions, while allowing challenges to proceed in egregious instances where a board was so remiss in its duties that it allowed an officer to subvert the compensation negotiation process. Under Delaware law, to avoid having the board take control of the litigation, the plaintiffs must raise a reasonable doubt either that the directors were not disinterested or independent or that the decision was not the product of a valid exercise of business judgment.[280] Of course, if the plaintiffs were able to raise a reasonable doubt about the directors' disinterest or independence, by for instance pleading facts tending to show that the directors were beholden to and under the domination of the officer in question, then demand would be excused.[281] But this, we think, usually will not be the case. In many instances, shareholders will not be claiming that the board is beholden to the CEO or other officer receiving the compensation,[282] only that the board effectively ceded to the officer the power to set his compensation by allowing that officer to capture the compensation process. More typically, the claim will assert that demand is excused because the board so ne-

279. *See* COX & HAZEN, *supra* note 3, § 15.05, at 428–29.

280. *See* Levine v. Smith, 591 A.2d 194, 207 (Del. 1991); Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

281. *Levine*, 591 A.2d at 205 ("When lack of independence is charged, a plaintiff must show that the Board is either dominated by an officer or director who is the proponent of the challenged transaction or that the Board is so under his influence that its discretion is sterilized." (citation omitted)).

282. Because criticism tends to focus on CEO compensation, and because CEOs are in a particularly good position to manipulate compensation negotiations, we expect most suits of the kind we sketch out here to be against CEOs. But the legal theories we discuss here would also allow suits against other officers similarly able to manipulate compensation negotiations.

glected or mishandled the compensation negotiations that its decision was not the product of a valid business judgment.

We expect that most suits targeting officers for excessive compensation will include two distinct claims. The first claim would be that the board acted with gross negligence in allowing the CEO to capture and undermine the compensation negotiation process; this claim is necessary to have demand excused.[283] The second claim would be that the officer violated her duty of loyalty in undermining and manipulating the process; this claim would be at the heart of the suit. Subsequently, the directors may be able to escape liability for gross negligence if their corporation's charter includes a section 102(b)(7) exculpatory clause, but this clause will not change the fact that demand was excused and will not prevent the main claim against the officer for breach of duty of loyalty from proceeding.[284]

This may seem an unusual way to construct a claim, but in a remarkably instructive case, the Chancellor has already shown how it could be done. Like the hypothetical case sketched out above, *McPadden v. Sidhu*[285] involved allegations that a board of directors was grossly negligent in allowing a corporate officer to manipulate a process to his economic advantage.[286] In *McPadden*, the board of i2 Technologies wished to sell a recently acquired subsidiary.[287] To run the sale, it chose the subsidiary's vice president, who was himself interested in purchasing the subsidiary.[288] According to the complaint, the officer then arranged an auction which excluded other serious bidders and allowed the officer and his allies to purchase the subsidiary for a sum well below what it was worth.[289] The shareholder-plaintiffs subsequently filed a derivative suit against both the directors and the officer, alleging that they

283. *See Aronson*, 473 A.2d at 804. The claim will not merely be that the board acted with imperfect information, for this would not necessarily constitute gross negligence. *See* Brehm v. Eisner, 746 A.2d 244, 259 (Del. 2000). We expect that the totality of the circumstances will have to show gross negligence, and withheld information will be only one element of that claim.

284. *See* Guttman v. Huang, 823 A.2d 492, 501 (Del. Ch. 2003). Under Delaware law, the board could still create a special committee of independent directors that could retake control of the litigation. *See* Zapata Corp. v. Maldonado, 430 A.2d 779, 785 (Del. 1981).

285. 964 A.2d 1262 (Del. Ch. 2008).

286. *Id.* at 1264.

287. *Id.* at 1263.

288. *Id.*

289. *Id.* at 1264–65.

acted in bad faith. Defendants responded by claiming that demand was not excused.[290]

Plaintiffs asserted that demand was excused because the i2s board's "approval of the sale was not fully informed, not duly considered, and not made in good faith for the benefit of the Company," and so was not entitled to the protection of the business judgment rule.[291] Chancellor Chandler rejected the assertion that the board acted in bad faith, with its implication that the board violated its duty of loyalty.[292] He agreed with plaintiffs, however, that they had sufficiently pleaded facts showing that the board had acted with gross negligence in the sale, thereby violating its duty of care.[293] The Chancellor found that, even though i2's board had expert advice on the sale, its refusal to consider reasonably available information and its decision to task a self-interested officer with running the sale created a reasonable doubt that its actions were the product of valid business judgment, and so demand was excused.[294] However, the company's charter included a section 102(b)(7) exculpation clause, so Chancellor Chandler dismissed the duty of care claims against the directors for failure to state a claim.[295]

Had the suit only been against the directors that would have been the end of it. But plaintiffs in *McPadden* had also sued the officer for, among other items, violating his duty of loyalty.[296] Section 102(b)(7) serves to protect directors, but not officers, against claims of duty of loyalty violations, so it did not extinguish the plaintiffs' claim against the officer.[297] Furthermore, as the Chancellor pointed out, he had "already concluded that demand is excused as futile, meaning that plaintiff has the right to prosecute this litigation on behalf of the Company."[298] While the case could not go ahead against the directors, "the claim [against the officer] for breach of fiduciary duty may, without a doubt, proceed."[299]

290. *Id.* at 1264.
291. *Id.* at 1270.
292. *Id.* at 1274–75.
293. *Id.*
294. *Id.* at 1271.
295. *Id.* at 1275.
296. *Id.* at 1275–76.
297. *Id.* at 1275.
298. *Id.*
299. *Id.*

As should be clear, we expect that *McPadden* could serve as a template for shareholder lawsuits alleging that officers have breached their fiduciary duties in negotiating compensation agreements. Like the cases we foresee, *McPadden* involved allegations of a negligent board, a self-interested officer, and a negotiation process that the officer was allowed thoroughly to corrupt through board inattention.[300] The analogy to executive officer employment contracts seems quite compelling to us.[301] While Chancellor Chandler noted the "perhaps unusual circumstances" of *McPadden*,[302] our approach can be successful with only a few such cases. In fact, we anticipate that only outlier compensation arrangements will stimulate litigation.

Neither the *Elkins* and *Disney* decisions nor *McPadden* spell out all the steps that a shareholder would need to take to enforce officers' fiduciary duties through litigation. We can, though, delineate some steps that a court would have to follow in litigation where a plaintiff alleges that an officer violated his fiduciary duties in extracting excess compensation from a company (assuming plaintiffs succeed in having demand excused). As explained above, when an officer begins negotiations for a subsequent employment contract, he would have a duty to negotiate his contract in an arm's-length and adversarial manner. Should a shareholder-plaintiff complain that those negotiations were flawed and offer sufficient factual allegations to create a reasonable doubt that this was the case, as in *Elkins*, then the officer would have the burden of demonstrating that the negotiations were arm's length and adversarial. Should the officer fail to carry this burden, a court would find that he breached his fiduciary duties by manipulating the negotiation and ap-

300. *Id.* at 1264–68.

301. For example, in *McPadden*, the Chancellor took the board to task for placing the executive in charge of selling a division of the company that it knew the executive was also interested in purchasing. *Id.* at 1271. In an executive employment contract negotiation, allowing the executive to control the process of negotiating her own contract and compensation would seem to be a similarly invalid exercise of the board's business judgment.

302. *Id*. We note that the plaintiffs in *McPadden* used a section 220 books and records demand to gather the necessary information to investigate the underlying circumstances surrounding the transaction prior to filing their derivative suit. As one of us has previously written, section 220 is an excellent, if costly, method for obtaining the discovery needed to particularize the allegations in a derivative suit. *See* Randall S. Thomas, *Improving Shareholder Monitoring of Corporate Management by Expanding Statutory Access to Information*, 38 ARIZ. L. REV. 331, 359 (1996). We envision it being used routinely by plaintiffs in the cases we are concerned with in this Article.

proval process. If the officer "manipulated the process, he cannot benefit from the decisions reached through that process."[303] Thus, neither compensation committee nor board approval will cleanse the breach of fiduciary duties that occurred.

This leaves several unanswered questions. First, assuming that full disclosure was subsequently made of all the relevant facts, would a majority of the disinterested shareholders then be able to approve the officer's breach of fiduciary duties?[304] While until now the procedures provided for conflict-of-interest transactions in DGCL section 144 have been used to cleanse directors' conflicted transactions, the section speaks of "a contract or transaction between a corporation and [one] or more of its directors or officers."[305] It should apply in the employment contract context; however, for approval to be valid, shareholders would have to be told of the "material facts" relating to the "relationship or interest and as to the contract or transaction."[306] In other words, shareholders would have to be told that the officer had manipulated the process in order to be fully informed in their voting.[307] Having to provide this information to shareholders would presumably help to keep the board on its toes. It would also give boards strong incentives to provide a form of say-on-pay for shareholders in situations where there might be reason to doubt the legitimacy of the underlying contract itself.

Second, assuming a court determined that an officer did breach his or her duties while negotiating a subsequent employment contract, what would be the next step? In a comparable situation, where a director breached his fiduciary duties in a conflict-of-interest situation, the burden would be placed on that director to demonstrate the entire fairness of the transaction, meaning the director would have to show both fair dealing and fair price.[308] By analogy, an officer would have to make the same showing. This suggests that a reviewing court would re-

303. Official Comm. of Unsecured Creditors of Integrated Health Servs., Inc. v. Elkins, No. Civ.A. 20228-NC, 2004 WL 1949290, at *17 (Del. Ch. Aug. 24, 2004).

304. Disinterested director approval would presumably not be possible because the underlying claim in the case would be that the board was uninformed about the various manipulative actions committed by the CEO as part of the negotiation process. Vice Chancellor Noble reached just this conclusion in *Elkins*. *See id.* at 9–19.

305. DEL. CODE ANN. tit. 8, § 144(a) (2001).

306. *Id*. § 144(a)(2).

307. *Id.*

308. *See, e.g.*, Weinberger v. UOP, 457 A.2d 701, 711 (Del. 1983).

quire the officer to demonstrate both that the contract was a product of fair dealing and that the corporation was paying a fair price for the officer's services.[309] However, in the first step of the court's analysis, it has already concluded that the contract was negotiated in an unfair manner to the corporation. Does this mean that the officer is unable to demonstrate entire fairness in any circumstances, since fair dealing is lost? Or does it simply place a higher burden upon the officer to show that the contract was fairly priced for the services that the corporation received? Third, if the court determined that the transaction (i.e., the compensation agreement) was not entirely fair, what would the consequences be for the directors and the officer? For most director-defendants, the consequences would probably not be significant. Assuming that the directors did not consciously collude in providing the officer excessive compensation, the most damaging claim against them would be that they acted carelessly, and even where it found that they had acted with gross negligence, monetary damages against them would almost certainly be extinguished by a section 102(b)(7) charter provision.[310] For the officer, though, the consequences would be more dire. Having found that the officer violated his duty of loyalty to the corporation, a court could order restitution and require that the officer return to the corporation any sum beyond which he would have received in a fair agreement.[311] Alternatively, the court could order rescission of the agreement and require the officer to disgorge all compensation received from the flawed compensation agreement.[312] Some courts would likely shy away from such a harsh result, but others might well welcome such a consequence for its salutary *in terrorem* effect.

309. A fair price determination, if needed, could require the Court to compare the compensation paid to that at comparable companies, and determine if the amount was such an outlier in relation to what other firms paid that it was unfair to the company. This procedure could be adopted from the method employed by courts in tax cases for close corporations where they are required to determine if the compensation payments are reasonable. *See* Vagts, *supra* note 74, at 257–61.

310. *See In re* Walt Disney Co. Derivative Litig., 825 A.2d 275, 286 (Del. Ch. 2003).

311. *See* Langevoort, *supra* note 16, at 1205 (noting the availability of civil damages for breach of duty of candor); Yablon, *supra* note 154, at 1901 (suggesting that damages from a similar suit, where courts had adopted a proportionality test to measure executive compensation, would be moderate).

312. Langevoort, *supra* note 16, at 1205–06 & n.78 (citing RESTATEMENT (SECOND) OF AGENCY § 469 (1954)).

The very possibility of such litigation, even in a small number of situations, will, we expect, serve to discipline compensation negotiations even at firms whose shareholders never resort to the courts. First, such occasional lawsuits that do make their way through the courts will give Delaware judges the opportunity to develop and promulgate a set of best practices to be followed in negotiating these compensation agreements, much as during the 1980s and 1990s they developed special procedures for boards to follow when selling companies to managers or controlling shareholders (transactions similarly rife with possible self-dealing).[313] While improved procedures will help to ensure that the board is better informed, we think that the possibility of such suits will also affect the advice given to executives and boards about these agreements and their negotiation. As Charles Yablon has noted, "[m]ost legal regulation of corporate behavior does not take place in court, but in lawyers' offices, as corporate lawyers counsel their clients as to what they must do to avoid legal 'problems' in connection with the actions they want to take."[314] The threat, however remote, of the kind of lawsuit sketched out here could provide significant incentives for CEOs to ensure that their compensation agreements were negotiated in an arm's-length and adversarial manner, and more generally to avoid overreaching in such negotiations.[315]

The advantages to this approach, in light of both history and theory, should be clear. As the above historical account shows, courts have at times been willing to inquire into allegedly excessive executive compensation.[316] The approach advocated here asks courts to evaluate the negotiation process used in reaching a compensation agreement, and evaluating process is something in which Delaware's judges are particularly skilled, and only if there are significant defects, would they need to address the reasonableness of pay levels. It also addresses a central concern of the Board Capture theorists. While Board Capture theorists may speak of a captive board, their particular claim is that executives have captured the process by which ex-

313. *See* Jeffrey N. Gordon, *Executive Compensation: If There's a Problem, What's the Remedy? The Case for "Compensation Discussion and Analysis,"* 30 J. CORP. L. 675, 689–90 (2005) (noting Delaware courts' "special judicial vigilance" over such self-interested transactions and pointing out the courts' comparative lack of vigilance over executive compensation).

314. Yablon, *supra* note 154, at 1897.

315. *See id.* at 1897–900.

316. *See supra* Part II.

ecutive compensation is set.[317] The approach set out here calls for courts to scrutinize closely that process.[318]

317. *See* BEBCHUK & FRIED, *supra* note 9, at 32–44 (discussing the pay-setting processes and analyzing whether boards are indeed bargaining at arm's length).

318. Some will see similarities between our approach and Congress's approach regarding mutual fund advisory fees. In 1970, concerned about high advisory fees, Congress added section 36(b) to the Investment Company Act, imposing a fiduciary duty on investment advisors regarding compensation they receive from investment companies, and giving shareholders a private right of action to enforce this duty. *See* Investment Company Amendments Act of 1970, Pub. L. No. 91-547, § 20, 84 Stat. 1413, 1428–30 (1970) (codified as amended at 15 U.S.C. § 80a-35 (2006)). Section 36(b) has, however, proven toothless; despite numerous suits, no mutual fund shareholder has *ever* won a case under it. *See* William A. Birdthistle, *Investment Indiscipline: A Behavioral Approach to Mutual Fund Jurisprudence*, 2010 U. ILL. L. REV. 61, 88. Will our approach work any better? We think so, for several reasons. Most important, courts applying section 36(b) have developed a remarkably narrow approach to evaluating claims of excessive fees (i.e., fees violating the advisor's fiduciary duty). Courts evaluating such claims typically invoke a multifactor test first set out in *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*, whose factors include rates charged by other advisors and the "nature and quality of the service" provided. 694 F.2d 923, 927–30 (2d. Cir. 1982); *see also* Jones v. Harris Assocs. L.P., 130 S. Ct. 1418, 1410–21 (2010) (commending the *Gartenberg* factors in evaluating claims under section 36(b)). According to *Gartenberg*, however, the point of the test is to determine whether the fee was "so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining." *Gartenberg*, 694 F.2d at 928 (citation omitted). In other words, this approach first asks a court to evaluate the substance of compensation—a task that, we have shown, courts dislike—but then tells the court that an advisor's compensation violates its fiduciary duty only if it verges on waste—a standard almost impossible to meet. *See* Donald C. Langevoort, *Private Litigation to Enforce Fiduciary Duties in Mutual Funds: Derivative Suits, Disinterested Directors and the Ideology of Investor Sovereignty*, 83 WASH. U. L.Q. 1017, 1023 (2005). Little wonder that courts consistently reject section 36(b) claims. Our approach, as should be clear, is quite different. It does not ask the chancery court to weigh the substance of an executive compensation decision; instead, the court is to make the more familiar inquiry whether process, in this case the negotiation of an executive's compensation agreement, was proper. Nor is "waste" a part of the evaluation. Courts' willingness to find for plaintiffs under these two approaches may also differ. While a federal court may now be unlikely to find for a shareholder making a section 36(b) claim, simply because such claims have *always* lost in the past, Delaware courts are not similarly hobbled in challenges to executive compensation. Plaintiffs usually lose such claims, but some have enjoyed some success in litigation challenging executive compensation, demonstrating that the courts are not completely unwilling to entertain such claims. Thomas & Martin, *supra* note 14, at 571. In sum, while our approach shares superficial resemblances to the approach mandated by section 36(b), in substance the approaches are quite different and will, we believe, result in different outcomes.

The innovative analysis pioneered in *Disney* and *Elkins* should be more broadly adopted by the Delaware courts. In addition to providing much-needed substance to the concept of officers' fiduciary duties in the executive compensation setting, it also addresses one of the major criticisms of executive (particularly CEO) compensation practices in public corporations: that many executive compensation agreements are products of sweetheart deals and that the terms of these deals are influenced by the personal relationships senior managers have among themselves and with the board of directors.[319] As it further articulates and applies this approach, the chancery court will be developing clearer boundaries between permissible and impermissible forms of negotiations.

VI. THEORETICAL RESPONSES

We believe the approach set out above can curb overreaching in abusive executive compensation agreements in practice, but will it work in theory? Can it respond to the distinctive concerns of Board Capture theorists, and, if so, will it also be acceptable to advocates of that theory's main rival, Optimal Contracting? We believe our approach will be acceptable to both camps. Indeed, one of the advantages of the approach set out here is that it may reconcile these apparently irreconcilable theoretical approaches. Board Capture theorists will welcome renewed scrutiny of the seemingly incestuous relationships among officers and directors, while Optimal Contracting theorists will see it as an improvement to the contracting environment and a remedy for those rare instances where officers have extracted unmerited compensation from their employers.

First, if our approach is adopted by the courts, it will answer many of the criticisms leveled by Board Capture theory's advocates against existing processes for negotiating executive employment contracts and setting compensation levels. When a corporate insider becomes a CEO, presumably benefiting from an allegedly cozy relationship with corporate directors,[320] courts will look more closely at her employment contract be-

319. *Cf.* BEBCHUK & FRIED, *supra* note 9, at 31–34 (discussing the social and psychological factors that "encourage directors to go along with compensation arrangements that favor the company's CEO").

320. Lower-level corporate officers often have the advantage of sitting on the board, or at least interacting with the directors prior to their selection as CEO, and therefore developing relationships with other directors before being nominated to the top job.

cause she was a fiduciary at the corporation prior to becoming CEO. By comparison, outsiders have no previous employment relationship with the firm and therefore cannot have developed similar relationships with board members. As a result, courts will not apply officer fiduciary doctrines to these contract negotiations. Thus, Board Capture theorists would welcome our approach as it focuses attention on the employment contracts they believe are most likely to be tainted.

More broadly, Board Capture theory is concerned that executives have overly cozy ties to the directors of their firms and that those directors will be overly generous to, or even in the back pockets of, the executives.[321] Our approach should lead to disclosure of any such relationships. Stricter standards for disclosure of any connections between board members and executives or of undue influence by executives on compensation consultants or compensation committee members should help cast sunlight on any behind-the-scenes deals. If the negotiations are sufficiently tainted, our approach will also lead to the compensation arrangements being overturned and potential damage remedies against the officer responsible. Such judicial action should warm the hearts of Board Capture theorists as it will address their complaint of close relationships between board members and firm officers.[322]

So far we have focused on Board Capture theory and argued that under this theory stricter judicial scrutiny is viewed as beneficial. Would that also be true under Optimal Contracting theory? Optimal Contracting theory claims that top officers' employment contracts are designed to maximize shareholder value net of contracting costs and transactions costs.[323] This does not mean that these executives' contracts look like contracts negotiated between two parties of equal negotiating strength in an arm's-length transaction,[324] for such contractual perfection seems unattainable. Instead, Optimal Contracting theory observes that in our current corporate governance system, managers do have a strong influence over the nomination of directors and it thus postulates that observed contracts anticipate and try to minimize the costs of this power.[325] While

321. *See, e.g.*, BEBCHUK & FRIED, *supra* note 9, at 31–34.

322. *Cf. id.* at 94 (commenting on the relationships and degree of influence between board members and CEOs).

323. Core et al., *supra* note 6, at 1160.

324. *Id.* at 1163–64.

325. *Id.* at 1160–64.

contract structures reflect executives' power, and executives with more power get more pay, an optimal contract "maximizes the net expected economic value to shareholders after transactions costs (e.g., contracting costs) and payments to employees" so that it minimizes agency costs.[326] In other words, an optimal contract is not perfect, but rather is the best contract that can be achieved to maximize shareholder value given the contracting costs in a particular corporate governance setting.[327]

Optimal Contracting theory accepts that American boards of directors are not completely independent.[328] While we could design a corporate governance system where a corporate board is almost completely independent of the CEO (leaving aside such imperfections as the fact that internally promoted CEOs will know the board members and even externally hired CEOs are likely to know at least some of the board members), this may not be optimal. For one thing, a corporate board has many other responsibilities besides contracting with executives about compensation, and to best fulfill these responsibilities may necessitate a nonindependent board. A board that is optimized for making compensation decisions could destroy value by making bad decisions on operational performance. Thus, the board structure that maximizes overall share value may not be comprised entirely of independent directors.[329] Under Optimal Contracting theory, the optimal compensation contract with the executive is not the one that results from the arm's-length bargaining of an independent board; it is the one that maximizes net shareholder value given that the board is optimized to perform several functions.

Optimal Contracting theorists claim that current U.S. corporate governance is likely to be "extremely good given the existence of information costs, transactions costs, and the existing U.S. legal and regulatory system."[330] This, in turn, leads to the conclusion that executive compensation agreements negotiated by corporate boards will be good, taking into account the fea-

326. John E. Core et al., *Executive Equity Compensation and Incentives: A Survey*, 9 ECON. POL'Y R. 27, 27 (2003).

327. *See* Core et al., *supra* note 6, at 1160.

328. *See id.* at 1162.

329. *See id.* at 1162–63.

330. *Id.* at 1161. Conceivably, improved regulation or other changes to the contracting environment could lower contracting costs and improve overall governance by, for example, making boards more independent and effective monitors, without impairing their ability to assist the corporation's officers in their operational functions.

tures of our corporate governance system.[331] Thus, when a new top officer is hired, optimal contracts are expected to be structured ex ante to take into consideration that the executive will ex post build managerial power over time.[332] Such contracts will ensure that the officer does not earn excess pay.[333] Simply showing at a given point in time that a manager has power says little about whether a firm has contracted optimally with the manager, or whether the manager earns excess pay in expectation over his or her tenure as manager. The important question is whether it leads to bad outcomes for shareholders.

Litigation is part of the background corporate governance system that underlies all negotiations between boards and top executives. Optimal Contracting theory claims that boards contract optimally given the corporate governance system's allocation of power between directors and officers.[334] If we strengthen the directors' position in contract negotiations, then that should affect the initial power of the two parties to the negotiations. The parties will then contract based on the new allocation of power.

Moreover, even Optimal Contracting theorists agree that there are a few bad apples.[335] Our proposal is tightly focused on the outliers in the compensation process, the instances where we find contracts that are far from the average in terms of their contract features or pay levels. When these type of contracts arise because of breaches of fiduciary duty, and not because of economic factors that might otherwise justify their existence, they would be suspect under our proposal. If courts can inexpensively and successfully identify and remedy cases where insiders have abused their positions to obtain excessive compensation packages, then they will also be remedying defects in the corporate governance system.

331. *See id.*

332. *See id.* at 1164.

333. *See id.* If the CEO already has power at the time of his initial employment, he will earn pay greater than he could with arm's-length bargaining. An optimal contract will take into account the fact that the initial contract will typically have a limited life of three or five years and seek to limit this power. *See* Stewart J. Schwab & Randall S. Thomas, *An Empirical Analysis of CEO Employment Contracts: What Do Top Executives Bargain For?*, 63 WASH. & LEE L. REV. 231, 235 (2006) (the most common lengths for CEO employment contracts are three and five years).

334. *See* Core et al., *supra* note 6, at 1161.

335. *See id.* at 1143–44.

This, in turn, should improve the underlying contracting environment that forms the backdrop for Optimal Contracting theory and therefore reduce contracting costs.[336] More generally, when the legal system successfully addresses a problem in the corporate governance system, the contracting environment becomes more efficient and shareholder wealth should increase.[337] The proposal set out in this Article should thus be welcomed by Optimal Contracting as well as Board Capture theorists.

CONCLUSIONS AND IMPLICATIONS

This Article identifies a theoretical impasse in our understanding of executive compensation and looks to recent developments in corporation law to find a practicable way out. At present, debates over executive compensation are waged between two scholarly camps. Advocates of Board Capture theory claim that boards of directors are dominated by corporations' CEOs and that those CEOs are able to set their own compensation, leading CEOs and other senior officers to take home pay packages that are both too high and provide too few incentives for improved corporate performance. Optimal Contracting theorists disagree. While admitting that a few compensation packages are inequitable, these theorists contend that, given the constraints of the current legal and regulatory system, most current CEO compensation agreements should be pretty good. They reward CEOs appropriately and, equally important, provide for increased shareholder value. Despite vigorous scholarly debate, however, little progress has been made in the theory of, and little has been done in practice to curb, excessive compensation packages.

A new avenue has been opened up by recent developments in corporation law that brings to life a neglected area: officers' fiduciary duties. In the *Gantler* decision, Delaware's supreme court recognized that corporate officers have the same fiduciary duties as do directors, and in two recent decisions its chancery court set out a road map showing how courts can review executive compensation agreements by scrutinizing the ways in which they were negotiated. While agreements between top executives and their corporations may never be truly at arm's length or adversarial, these two decisions describe what would

336. *Id.* at 1161–62.
337. *See id.* at 1162.

be necessary in such negotiations for a court to conclude that an agreement was not the product of an executive's power over the board of directors.

Critics of executive compensation have generally dismissed courts as effective monitors of executive pay. As we have shown, such a sweeping judgment is wrong. In several past episodes courts have been unsettled by high executive compensation and willing to scrutinize large pay packages. What courts have been consistently unwilling to do is to become pay czars. Our approach, focusing as it does on outlier pay arrangements and the process by which such compensation agreements are negotiated, should be welcomed by courts.

From a theoretical perspective, our approach should cheer both Board Capture and Optimal Contracting theorists. For Board Capture theorists, the Delaware courts' approach will provide a searching review of just the situation that they have been decrying for decades, CEO domination of the compensation process, with the promise that compensation agreements produced through managerial power will be struck down. Optimal Contracting theorists will welcome such review as well, not only because it will strike down outlier agreements that result from illegitimate influence ex post, but because it should improve the negotiating environment ex ante.

One important question remains: Will the Delaware courts actually adopt this approach and engage in rigorous review of compensation agreements? Board Capture theorists may be skeptical, as they have in the past held out little hope that courts are willing or able seriously to review excessive compensation. Yet, as this Article has shown, the true history of judicial review of compensation agreements is more complicated than a simple refusal to scrutinize compensation.

Courts have in the past imposed closer scrutiny on aspects of executive compensation and warned at other times that such scrutiny may be applied. The *Disney* and *Elkins* decisions should give hope that such scrutiny will again be forthcoming. For one thing, they focus on officers, not directors. If courts have been reluctant to place legal liability on directors because of fears that highly qualified individuals will be unwilling to take part-time positions and put their personal wealth at risk, this concern should be mitigated where we are talking about full time, highly paid employees who can avoid significant legal exposure by making full disclosure and engaging in arm's-length negotiations with fully informed boards of directors.

Moreover, there are persuasive arguments that officers' direct involvement in the management of the firm should result in greater scrutiny of their actions than those of outside directors.[338] These claims seem particularly compelling in conflict-of-interest situations such as overreaching in the negotiation of the officer's own employment contract. Finally, Delaware might want to seize an opportunity to firm up its claim that executive compensation is a matter for state law as a way of preempting federal action in the area. As others have pointed out in other areas of the law, if the United States perceives that executive compensation is out of control, and Delaware does not act, it risks having the federal government step in and take over the field.[339] For these reasons, we are hopeful that the Delaware courts will monitor executive employment contract negotiations in a meaningful way. If we are right, this would not only resolve the theoretical impasse discussed here, but have a significant practical impact on executive compensation contracts.

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338. Johnson & Millon, *supra* note 238, at 1607–08 (arguing that agency law should be used to define corporate officers' fiduciary duties).

339. *See, e.g.*, Marcel Kahan & Edward Rock, *Symbiotic Federalism and the Structure of Corporate Law*, 58 VAND. L. REV. 1573, 1584–88 (2005); Roe, *supra* note 216, at 643.