Courts Should Curb Executive Pay

The National Law Journal
By Daniel J. Morrissey
August 15, 2011

Social critics have long pointed out that corporate boards routinely sign blank checks that award lush remuneration to top executives of their companies. But not since the Great Depression have shareholders been able to successfully challenge those munificent pay packages. Courts, rather, have regularly deferred to what they call the business judgment of directors and turned away shareholder claims that such exorbitant and unearned recompense constitutes a waste of corporate assets. Things, however, may be changing.

Business journalists, bloggers and academic commentators are now identifying excessive compensation as the No. 1 problem in corporate governance, using words like "looting" and "theft" to describe those rich rewards. The outrageous nature of this remuneration has become particularly shocking when compared to the pay of most working Americans. While private-sector wages rose only by 2% in 2010 and unemployment remained dismally high, the median compensation for chief executive officers at Standard & Poor's 500 index companies was up by 18% from 2009 to an average of $12 million.

Those income statistics were not always so unequal. In 1965, the typical chief executive made 24 times the salary of the average worker. But from then until 2007, during years when worker productivity in our country continued to grow, that differential in earnings increased by more than tenfold to 275. Commenting on how management grabbed the lion's share of that increase in wealth, labor lawyer Thomas Geoghegan wrote: "In 2005 the real hourly wage for production workers in America was approximately 8% lower than it was in 1973, while our national output was 55% higher. So it's dubious whether most Americans have gained even a penny in purchasing power since 1989."

Recent economic studies also show how most of the income gain during the past decades was reaped by corporate executives and financiers. The headline of a special report in the *Washington Post* on June 18 summed up those findings: "With Executive Pay, Rich Pull Away from Rest of America." In the same vein, Nobel Prize-winning economist Joseph Stiglitz recently observed that the top 1% of earners now take in about a quarter of our nation's income and own 40% of its wealth. And data from the Federal Reserve show that the wealthiest 1% of Americans has a greater net worth than the bottom 90%.

A large portion of this undue executive pay has come from options granted them to purchase shares in their companies. Those are supposed to incentivize management and align their interests with their stockholders by tying their remuneration to increases in the market capitalization of their companies. But as Judge Richard Posner of the U.S. Court of Appeals for the 7th Circuit, the father of law and economics jurisprudence, remarked in the *Duke Law Journal*, that rationale is weak because "many things move a company's stock besides the decisions of its CEO."

In addition, compensation from options has been all too easy to game, most notoriously by the widespread practice of backdating their grant dates. But even leaving aside that patently illegal

practice, there are other ways that corporate officials can manipulate those awards to get lucrative paydays. They need only, for instance, have their firms issue stock and options to themselves when the price of those financial instruments is depressed.

Just recently, during the market's low point in late 2008 and early 2009, more than 90% of the CEOs at Standard & Poor's 500 companies received large numbers of those repriced grants. When stocks rebounded this spring, the awards netted those officers $3 billion. In addition, that surge gave them billions more in gains on the stock and options they already held. There is injustice and an obvious conflict of interest when a substantial drop in the price of a company's shares gives its executives an opportunity to profit, while its stockholders suffer serious misfortune.

Well-respected scholars of corporate law have also pointed out that CEO remuneration is not geared to rewarding the performance of those top officers. In their book *Pay Without Performance*, professors Lucian Bebchuk and Jesse Fried of Harvard Law School attacked what they call the "official view" that directors fix executive pay in arm's-length negotiations with corporate leaders to provide them incentives to increase shareholder wealth. In reality, those top executives set their own pay through captured boards that they control.

Corroborating that view, Posner has noted that directors generally come from the ranks of executives at other companies and thus have a vested interest in keeping the compensation of like-situated officials high. He has also pointed out that since CEOs influence the choice and pay of directors, "there is evidence of mutual back scratching — the directors authorizing generous compensation for the CEO and the CEO supporting generous fees for directors."

Changing Legal Standards

Last summer, as part of the Dodd-Frank Wall Street Reform Act, Congress enacted a "say-on-pay" provision that requires public companies to allow their shareholders an advisory vote on the compensation of their top officials. Although Dodd-Frank states that those expressions are not binding and do not alter the fiduciary duties of directors, companies have to promptly report the results and explain whether they will be taken into account by management. In addition, the U.S. Securities and Exchange Commission now requires extensive discussion of the policies that companies use in fixing their executive remuneration.

A recent and telling decision from the Delaware Court of Chancery may also signal a new and more realistic judicial understanding of those dynamics, indicating that corporate officers who have fiduciary duties to their firms are acting disloyally when they extract excessive compensation for themselves. In *In re Citigroup Inc. Shareholder Derivative Litigation*, 964 A.2d 106 (New Castle Co., Del., Ch., 2009), the court refused to dismiss a claim that more than $60 million awarded as severance to Citigroup's CEO Charles Prince was a waste of corporate assets, particularly in light of allegations that he was responsible for huge losses by the bank during the financial meltdown.

After stating the general authority of boards to set executive remuneration, the chancellor made this salient comment: "It is also well settled in our law…that the discretion in setting executive compensation is not unlimited. Indeed the Delaware Supreme Court was clear when it stated that

there is an outer limit to the board's discretion on executive compensation, at which point a decision of directors on executive compensation is so disproportionately large as to be unconscionable and constitute waste."

This renewed judicial willingness to strike down excessive corporate recompense may soon come into play in several suits brought against boards that have declined to rescind generous hikes to their top officials when shareholders stated their disapproval in negative say-on-pay balloting. Although the overwhelming majority of those elections have affirmed compensation decisions, several of the "no" votes came in response to lush raises granted when companies had suffered unprecedented losses. Those increases were particularly egregious because they came in derogation of corporate policy requiring that executive pay be based on performance.

Although those negative shareholder resolutions are not legally binding on boards, they are nevertheless probative evidence that directors have violated their duties to act in the best interest of their companies' stockholders. The cases challenging those decisions could send a much-needed message to boards that they must curb excessive executive awards and roll back some of the outlandish income inequality that is plaguing our society.

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