

Washington University Law Review

Volume 79

Issue 2 *Corporate Accountability*

January 2001

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Recommended Citation

Randall S. Thomas and Kenneth J. Martin, *Litigating Challenges to Executive Pay: An Exercise in Futility?*, 79 WASH. U. L. Q. 569 (2001).
Available at: http://openscholarship.wustl.edu/law_lawreview/vol79/iss2/5

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LITIGATING CHALLENGES TO EXECUTIVE PAY: AN EXERCISE IN FUTILITY?

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I. INTRODUCTION

In recent years, executive pay levels at publicly held corporations have increased dramatically.¹ Corporate boards have awarded Chief Executive Officer (CEO) pay packages valued at hundreds of millions of dollars. Stock option compensation has led the way, with mega-option awards in excess of ten million dollars now common at Fortune 500 companies.² Directors approving these staggering transfers of wealth justify them as “pay for performance.”³

Many shareholders, especially institutional investors, have been upset at the size of these awards. While they accept the idea that managers should receive large financial incentives to improve their company’s performance, these investors find that these large pay packages are often accompanied by little or no improvement in stock prices or other financial measures of success. In some cases, the worst performing companies are the ones giving their executives the fattest pay envelopes.

Although there are several methods by which shareholders may challenge compensation plans, their overall success in doing so has been very limited. Corporate law provides shareholders with three basic ways to influence

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** Professor of Finance, New Mexico State University College of Business and Economics. We would like to thank Brian R. Cheffins, James D. Cox, Roberta Romano, Vice-Chancellor Leo E. Strine, Jr., Robert B. Thompson, and the commentators and participants of the Washington University School of Law Institute for Law and Economic Policy’s conference on *Corporate Accountability*, for their extremely helpful comments. We would also like to acknowledge our excellent research assistant Chad R. Vanisko for his help in putting the data set together.

1. Randall S. Thomas & Kenneth J. Martin, *The Effect of Shareholder Proposals on Executive Compensation*, 67 U. CIN. L. REV. 1021, 1025 (1999). Overall compensation levels at public companies have jumped by 264 percent during the period from 1993 to 1997. *Id.* For excellent survey articles on executive compensation, see Mark J. Loewenstein, *The Conundrum of Executive Compensation*, 35 WAKE FOREST L. REV. 1 (2000); Tod Perry & Marc Zenner, *CEO Compensation in the 1990s: Shareholder Alignment or Shareholder Expropriation?*, 35 WAKE FOREST L. REV. 123 (2000).

2. Randall S. Thomas & Kenneth J. Martin, *The Determinants of Shareholder Voting on Stock Option Plans*, 35 WAKE FOREST L. REV. 31, 35 (2000).

3. *Id.* at 37.

corporate executive compensation decisions: voting, selling, and suing.⁴ Shareholders' ability to use their voting powers to reduce executive pay levels is weak. At the most extreme level, if a board overpays its CEO, shareholders can seek to remove the directors by shouldering the cost of proposing and promoting an alternative slate of directors in a proxy contest. These types of contests are rare and expensive.⁵ Today, they are usually launched at major public corporations when the company is the target of a hostile tender offer, never simply to dispute the size of an executive's pay package.

Shareholder proposals using Rule 14a-8⁶ frequently attack executive compensation practices. A favorite of individual investors, these proposals seldom gain more than ten percent of the votes cast at a shareholder meeting.⁷ While many boards do appear to respond to the more popular proposals by reducing the rate of increase of executive pay and shifting compensation away from options and into salary and bonus payments, these effects are relatively limited.⁸

Shareholders frequently have the right to vote on management proposals for stock option plans. Levels of shareholder opposition to these plans have increased substantially in recent years.⁹ In a few egregious cases, these plans have even been defeated. However, these votes do not appear to have slowed the rapid growth in stock option awards.

Selling decisions can be effective if large numbers of shareholders dump a company's stock due to concerns about its pay practices, but this is only feasible for investors whose portfolios have sufficient flexibility. Large institutional investors, particularly those whose holdings are indexed, may not have the ready option of selling their shares. In fact, it appears that few shareholders sell their shares out of frustration with firm compensation practices.¹⁰

This Article focuses on the last of shareholders' alternatives: suing. Shareholder derivative litigation has frequently been an engine for changing

4. See Robert B. Thompson, *Shareholders as Grown-Ups: Voting, Selling, and Limits on the Board's Power to "Just Say No,"* 67 U. CIN. L. REV. 999 (1999).

5. For further discussion of proxy contests by shareholders, see generally RANDELL S. THOMAS & CATHERINE DIXON, ARANOW AND EINHORN, *PROXY CONTESTS FOR CORPORATE CONTROL* 1 (3d ed. 1998).

6. 17 C.F.R. § 240.14a-8 (1987).

7. Thomas & Martin, *supra* note 1, at 1061.

8. *Id.* at 1069-70.

9. Thomas & Martin, *supra* note 2, at 47.

10. Letter from Stuart Gillian, Research Economist, TIAA-CREF, to Randall Thomas, Professor of Law, Vanderbilt University School of Law (June 15, 2000) (on file with authors).

abusive corporate practices.¹¹ The well-tested claims of breach of duty of care, breach of duty of loyalty, and waste, are available when the appropriate facts support them. In recent history, a large number of determined plaintiffs have brought such claims, challenging abusive corporate pay practices in corporations.

Are these suits successful? Using data from public files, this study examines a sample of 124 cases where shareholders have challenged executive compensation levels and practices at publicly and closely held corporations.¹² This data set shows that shareholders are successful in at least some stage of the litigation process in a significant percentage of these cases.

Our most robust result is that plaintiffs win a greater percentage of the time in compensation cases against closely held companies than against publicly held companies. This result is consistent for every stage of these cases; motions to dismiss, motions for summary judgment, trial, and appeal. We believe this result can be explained by the frequent presence of conflicts of interest and weaker procedural safeguards at most close corporations, as well as shareholder plaintiffs' improved access to information where they are more actively involved in the company. This litigation may also be pressed more vigorously because compensation usually comprises a bigger percentage of the profits of a closely held corporation than in a public corporation. In addition, plaintiffs usually hold a larger percentage of the company's stock and have had a falling out with the current management.¹³ This may make them more resolute opponents in litigation.

We also find that, on average, plaintiffs fare better in compensation cases in courtrooms outside of Delaware than in Delaware. However, once we control for the different composition of the Delaware courts' caseload, these differences disappear and the overall success rates in executive compensation litigation are surprisingly similar.

When we look at the procedural and substantive claims in these cases, we reach some other interesting results. Demand futility is a significant barrier to getting such suits off the ground. About half the time plaintiffs lose on a motion to dismiss for failure to make demand. In Delaware, motions to

11. This point is well-illustrated by paging through any recent corporate law casebook. *See, e.g.*, CHARLES R.T. O'KELLEY & ROBERT B. THOMPSON, CORPORATIONS AND BUSINESS ASSOCIATIONS (3d ed. 1999). The overwhelming number of cases influencing changes in corporate law are shareholder derivative actions.

12. *See infra* Parts II-IV for further discussion of these results.

13. One recurrent cause of shareholder litigation in close corporations are squeeze-outs of minority shareholders after internal disputes over control or management of the enterprise. For discussion of these cases, see generally F. HODGE O'NEAL & ROBERT B. THOMPSON, O'NEAL'S OPPRESSION OF MINORITY SHAREHOLDERS (2d ed. 2000).

dismiss for failure to make demand are raised much more frequently since the Delaware Supreme Court's decision in *Aronson v. Lewis*,¹⁴ although plaintiffs today seem to succeed in overcoming them a greater percentage of the time.

The picture is more complicated with respect to the substantive claims made in these cases. Plaintiffs average about a thirty percent success rate in maintaining duty of care claims at the various stages of these suits with slightly higher success rates in non-Delaware cases. However, since the Delaware Supreme Court's decision in *Smith v. Van Gorkom*,¹⁵ the number of these claims has increased and their likelihood of success at some stage of the litigation appears to have increased.¹⁶ With waste claims, plaintiffs succeed about forty percent of the time, while for duty of loyalty claims, they win about thirty-five percent of the time. For both types of claims plaintiffs are consistently more successful in close corporations than in public corporations.

After reviewing the data concerning the historical disposition of executive compensation cases by the courts, in Part III, we ask more generally if the law is evolving to create more fruitful avenues for shareholder litigation. We consider two potential changes in the legal standards. First, we scrutinize the American Law Institute (ALI) Principles of Corporate Governance and find that they create new obstacles for shareholder plaintiffs challenging executive pay abuses. Second, we examine the Delaware Supreme Court's most recent opinion on executive compensation matters, *Brehm v. Eisner*,¹⁷ and find that it offers little new ammunition for investors. We conclude that neither of these developments is likely to improve shareholders' likelihood of success in derivative suits challenging executive compensation.

Finally, in Part IV, we turn to a discussion of why the courts have not been more willing to scrutinize executive pay practices at public corporations. Historically, courts and commentators have offered several justifications for this practice: judges' inability to determine appropriate compensation levels, a lack of legislative guidance on compensation practices and the fear of creating excessive amounts of shareholder litigation.¹⁸ We analyze each of these arguments against increased judicial involvement, and find them partially persuasive. We claim that courts should

14. 473 A.2d 805 (Del. 1984).

15. 488 A.2d 858 (Del. 1985).

16. This conclusion is a very tentative one, as we have relatively few duty of care cases in our sample, and our results are not statistically significant.

17. 746 A.2d 244 (Del. 2000).

18. For further discussion, see *infra* Part IV.

have only a limited role in monitoring the procedural aspects of the executive compensation process and in policing the substance of outlier pay packages.

We conclude that if the courts are reluctant to inquire into the particulars of executive pay packages, and the state legislatures are unwilling or incapable of taking action, angry investors will need to seek out other avenues for correcting abuses in the executive pay area. Some shareholders may seek to strengthen existing approaches to directly influencing executive compensation through coordinated voting campaigns. However, if disgruntled shareholders want to have a more immediate impact on the size and composition of executive pay packages, they will need to shift their focus to other factors that affect current practices, such as the accounting treatment of stock options and executives' use of hedging transactions.

II. EXECUTIVE COMPENSATION LITIGATION

Shareholder litigation attacking a corporate board's decision to give a senior executive a particular pay package faces both procedural and substantive obstacles. The main procedural hurdle that plaintiff shareholders must overcome is the demand requirement that applies in derivative litigation. Should the plaintiffs overcome this obstacle, they face serious substantive difficulties in proving a claim for breach of duty of care, waste, or a breach of the duty of loyalty.

This Part examines the legal standards that apply in each of these situations, and looks at plaintiffs' success in meeting them in cases attacking executive compensation at corporations. It is broken into three sections: (1) derivative claims and the demand requirement, (2) duty of care and waste claims, (3) and duty of loyalty claims. We then discuss some evidence about the differences in how courts scrutinize pay at close corporations and public corporations, and the differences in how Delaware courts and non-Delaware courts treat these claims. Statistics are presented in each section to illustrate how successful plaintiffs have been in litigating each type of claim.

We obtained our cases from publicly available information in the Lexis and Westlaw databases and from citations in a variety of secondary sources on executive compensation. We gathered all of the cases that we could find where a court decided an issue about the process, size, or composition of an executive's pay. Our earliest case is from 1912, and our most recent cases were decided in 2000. We cannot claim, however, that we have found every case on executive compensation over this time period, only that we have tried to do so.

We read each case and recorded information on a number of different variables. These included: the date of the decision; whether the corporation

involved was closely held or publicly held; what type of motion, trial, or appeal was being decided by the court; what the outcome of that hearing was; what types of substantive and/or procedural claims were being raised; and what type of compensation was being challenged. Our final data set included 124 cases from 24 states.

Our sample limits our ability to address certain types of questions, which is inevitable in empirical research using judicial opinions. As Robert B. Thompson, a well-known author of such studies in the corporate law field wrote, "As with any empirical study, it is worthwhile to keep in mind what the study can and cannot do."¹⁹

There are two types of limitations that should be mentioned. First, for various reasons using judicial opinions as data means that we cannot answer questions, such as "how frequently do shareholders challenge board's executive pay decisions?" Many challenges are resolved without litigation either through informal discussions between the board and the company's investors, or by the plaintiff's counsel and the company before the plaintiff files a complaint. Also, many cases that are filed settle without any decision by the court, or result in an unreported decision that does not appear in the electronic databases we used.²⁰ Nor can we draw inferences about how happy shareholders are with the compensation practices of the boards of companies in which they invest because we cannot observe all of the different ways that shareholders may express their approval or disapproval.²¹

A second problem that we face is selection bias. In an influential article, George Priest and Benjamin Klein claimed that the settlement of litigation does not occur randomly, but rather it is a function of the underlying

19. Robert B. Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 CORNELL L. REV. 1036, 1046 (1991).

20. The ratio of opinions issued to cases filed is usually low. For example, in an earlier study that we conducted of the Delaware stocklist statute, section 220 of the Delaware General Corporation Code, we found ninety-one cases filed under the statute during the period 1992-1994. Randall S. Thomas & Kenneth J. Martin, *Using State Inspection Statutes for Discovery in Federal Securities Fraud Actions*, 77 B.U. L. REV. 69, 102 (1997). A search of Lexis-Nexus for Delaware chancery court decisions revealed only ten judicial opinions on section 220 cases during the same time period. Thus in Delaware, one estimate of the ratio of opinions issued to cases filed might be about ten percent. This estimate is probably quite high for most states, and even for Delaware historically, because it includes a large number of unreported decisions: of these ten decisions, only two were reported decisions. Delaware is unlike many other states in that its unreported decisions have precedential value and are therefore made available by the electronic case services, such as Lexis, at least as of the 1980s. For states which do not make unreported decisions available, then two percent might be a more realistic estimate.

21. These would include selling their stock in such companies, voting against the board of directors of these firms, and voting against the companies' stock option plan proposals, to name a few. See Thomas & Martin, *supra* note 1, at 1043-55 (examining several different methods by which shareholders make their views on compensation known to directors).

uncertainty about the applicable legal rules.²² Where the law is highly certain, the parties will usually be able to determine for themselves what the appropriate outcome of the dispute should be and, therefore, settle the matter without resort to a judicial decision.²³ The cases that are selected for litigation, they claimed, are those in which there is greater uncertainty about the outcome.²⁴

From this basic proposition, Priest and Klein developed a second, much more controversial, claim that in the cases selected for litigation, the probability of plaintiff success approaches fifty percent.²⁵ The underlying intuition behind this claim is that the cases most likely to be selected for litigation are those in which the plaintiff and the defendant both have a fifty percent chance of winning the case. This claim led to the creation of a body of empirical literature, which largely rejected the fifty percent hypothesis in a wide variety of settings.²⁶ These studies consistently found that plaintiffs' success rates are less than the predicted fifty percent.

Kessler, Meites, and Miller have tried to explain these observed divergences from the fifty percent rule using a multimodal model that takes into account seven different factors that can account for deviations from the hypothesis.²⁷ Two of their seven factors may be present in the data underlying this study: differential stakes in the litigation²⁸ and agency effects.²⁹ We will return to explore these effects after our discussion of our empirical results.

However, we wish to emphasize that what we are most concerned with in this study is the relative rates of success of plaintiffs in compensation cases. We want to compare how plaintiffs do on different types of claims against different types of defendants. Their absolute success rates in compensation cases are less critical to our analysis.

22. George L. Priest & Benjamin Klein, *The Selection of Disputes for Litigation*, 13 J. LEGAL STUD. 1 (1984). See also George L. Priest, *Reexamining the Selection Hypothesis: Learning from Wittman's Mistakes*, 14 J. LEGAL STUD. 215 (1985).

23. Priest & Klein, *supra* note 22, at 16-17.

24. *Id.* at 17.

25. *Id.*

26. For a survey of this literature, see Daniel Kessler et al., *Explaining Deviations from the Fifty-Percent Rule: A Multimodal Approach to the Selection of Cases From Litigation*, 25 J. LEGAL STUD. 233 (1996).

27. *Id.*

28. Their claim is that the party with the greater stakes in the litigation is likely to have a higher degree of success in the litigation. *Id.* at 238, 242. For further discussion of this point, see *infra* Part II.G.

29. By agency effects, the authors are referring to the potential divergence between the interests of the litigants and those of their attorneys. Kessler et al., *supra* note 26, at 246.

A. *Derivative Claims and Demand Futility*

Shareholders challenging board decisions to pay executives high levels of compensation almost invariably file derivative actions, claiming an injury to the corporation that indirectly harms its shareholders.³⁰ Because derivative claims are claims brought on behalf of the corporation, they are subject to a variety of procedural safeguards. The most important of these safeguards is the demand requirement.

In a derivative case, the shareholder must make a demand on the board of directors of the corporation to take action to correct the wrongdoing, or allege that such a demand would be futile.³¹ The Delaware Supreme Court has stated that the demand requirement has several benefits.³² First, it requires exhaustion of all intracorporate remedies, thereby possibly avoiding litigation altogether. Second, it gives the corporation an opportunity to pursue claims that its board of directors believes are meritorious, and to seek dismissal of the others. Finally, in situations where demand is excused because it is futile, or is wrongfully refused by the board of directors, the plaintiff shareholder is free to pursue its action in the manner it believes best.

If the shareholder makes a demand on the board to pursue the action, then in most cases, this demand effectively shifts control over the suit to the board.³³ Typically, a board will move to dismiss derivative litigation if a demand is made and, if the board appears to have acted independently and to

30. Attacks on executive pay are derivative because they typically allege that the company overpaid the executive and thus diminished the value of the corporation.

31. JAMES D. COX ET AL., CORPORATIONS § 15.1-22 (2001) [hereinafter COX, CORPORATIONS]. The Model Business Corporation Act (MBCA) has proposed that states adopt a universal demand requirement. See MODEL BUS. CORP. ACT § 7.42 (1999). For further discussion of this proposal, see *infra* Part III.A.

32. Brehm v. Eisner, 746 A.2d 244, 255 (Del. 2000) (quoting Grimes v. Donald, 673 A.2d 1207, 1216-17 (Del. 1996)).

33. The Delaware Supreme Court recently clarified the law in this area in *Scattered Corp. v. Chicago Stock Exchange, Inc.*, 701 A.2d 70 (Del. 1997). In that case, the court held that a shareholder does not concede the defendant board's disinterest and independence in every case where the shareholder has made demand on the board of directors. Instead,

[i]f there is reason to doubt that the board acted independently or with due care in responding to the demand, the stockholder may have the basis *ex post* to claim wrongful refusal. The stockholder then has the right to bring the underlying action with the same standing which the stockholder would have had, *ex ante*, if demand had been excused as futile It is not correct that a demand concedes independence "conclusively" and in futuro for all purposes relevant to the demand [A] board that appears independent *ex ante* may not necessarily act independently *ex post* in rejecting a demand. Failure of an otherwise independent-appearing board or committee to act independently is a failure to carry out its fiduciary duties in good faith or to conduct a reasonable investigation. Such failure could constitute wrongful refusal.

Id. at 74-75 (citations omitted). However, plaintiffs who seek to establish wrongful refusal of a demand will undoubtedly bear a heavy burden.

have conducted a reasonable investigation of the allegations in the plaintiff's complaint, a court will generally grant this motion.

As a result, most shareholder plaintiffs in derivative actions will allege that demand on the board is futile. However, under *Aronson v. Lewis*,³⁴ establishing demand futility requires the plaintiff to plead particularized facts that create a reasonable doubt that a majority of the board of directors are independent, or that the challenged payments are not protected by the business judgment rule.³⁵ It is a difficult burden to carry in the initial stages of litigation, especially because the plaintiff must do so without the benefit of discovery.³⁶

The plaintiff's best hope is to show that a majority of the board of directors is financially interested in the compensation decision so as to satisfy the first prong of the *Aronson* test. This showing requires facts that would support such a taint of conflict of interest, facts that are more likely to be present in closely held companies than in public corporations. Many public

34. 473 A.2d 805 (Del. 1984).

35. *Id.* at 814. *Aronson* illustrates the difficulty of satisfying this test. There, the court held that the first prong of the test is not satisfied where the executive whose compensation was challenged selected the directors and owned a large share of the company's stock. *Id.* at 815-16. Rather, there must also be facts which show that "through personal or other relationships the directors are beholden to the controlling person." *Id.* at 815. See Mark J. Loewenstein, *Reflections on Executive Compensation and a Modest Proposal for (Further) Reform*, 50 SMU L. REV. 201, 212 (1996) (discussing *Aronson* and pointing out that these allegations will be difficult for a plaintiff to plead when she is not yet entitled to discovery).

36. The Delaware Supreme Court has repeatedly stated that derivative plaintiffs should take advantage of the "tools at hand" to develop the facts needed to meet these pleading requirements. See, e.g., *Brehm*, 746 A.2d at 266. In particular, the court has encouraged plaintiffs to use the Delaware books and records statute as a pre-filing discovery mechanism to uncover evidence of corporate mismanagement. The idea is that a serious plaintiff shareholder will file a books and records case in the Delaware Chancery Court to obtain information about potential wrongdoing at a company prior to drafting a derivative complaint attacking the alleged misdeeds.

Plaintiff shareholders have not rushed to take up this invitation. As one of the authors wrote in an earlier article discussing this question, there appear to be good reasons for the lack of response. See Randall S. Thomas, *Improving Shareholder Monitoring of Corporate Management by Expanding Statutory Access to Information*, 38 ARIZ. L. REV. 331, 360 (1996). These reasons include the fact that plaintiffs only obtain any access to corporate books and records in two-thirds of the cases filed under the Delaware statute, even when they seek to investigate corporate mismanagement. Second, the costs and delays involved in bringing such an action are considerable. Plaintiffs are in essence required to litigate and win a case in order to determine if they have enough evidence to meet the pleading requirements for their derivative claims. Finally, the Delaware courts have restricted plaintiffs' access to those categories of documents that are "essential" to their investigation and, within this limited group of categories, required that the plaintiff "make specific and discrete identification, with rifled precision, of the documents sought." *Brehm*, 746 A.2d at 266-67 (emphasis added). While this last group of limitations may serve the laudatory purpose of keeping plaintiffs from engaging in fishing expeditions using an expedited statutory procedure, they make the books and records statute useful mostly to plaintiffs who already know enough about the fraud that they can satisfy *Aronson's* pleading requirements.

corporations have compensation committees comprised mostly, if not exclusively, of disinterested outside directors. The effect of such a committee is that it will often “erect an unsurpassable barrier in the plaintiff’s quest to challenge executive compensation.”³⁷

The second prong of *Aronson* requires the plaintiff to plead facts that show that the decision concerning the challenged compensation was not the product of a valid exercise of business judgment.³⁸ The plaintiff is required to show that the board either failed to satisfy its procedural due care duties by not being adequately informed of all material information reasonably available, or committed waste, that is, failed its substantive due care obligations by making an irrational decision.³⁹ Few plaintiffs are able to make a sufficient showing at this stage in the litigation to get over this hurdle.

The facts in *Aronson* illustrate the difficulty that plaintiffs face in pleading demand futility in Delaware. Plaintiffs in that case challenged an employment agreement between Meyers Parking System, Inc. and its forty-seven percent shareholder and director Leo Fink, who was seventy-five years old.⁴⁰ Fink’s employment contract had a five-year term with an automatic, indefinite renewal each year thereafter paying Fink \$150,000 in salary each year. Upon termination, Fink would continue to receive the same pay for three years, \$125,000 for another three years, and after that, \$100,000 per year for the rest of his life. All of these payments were to be made even if Fink was unable to perform any services for the company.⁴¹ In addition, the company made interest-free loans of \$225,000 to Fink.⁴²

The complaint alleged that these transactions constituted a corporate waste. It claimed that demand on the board would be futile because Fink had personally selected the members of the board, that he dominated and controlled them, and that collectively the board controlled 57.5 percent of the company’s stock. Despite these allegations, the Delaware Supreme Court concluded that the defendants had not established demand futility and dismissed the complaint.⁴³

Tables 1 and 2 illustrate the effect of the demand requirement on suits challenging executive compensation. Table 1 analyzes the frequency with

37. COX, CORPORATIONS, *supra* note 31, § 11.5.

38. *Aronson*, 473 A.2d at 814.

39. *Brehm*, 746 A.2d at 258-64.

40. *Aronson*, 473 A.2d at 808-09.

41. The trial court noted that two other directors had contractual arrangements similar to Fink’s, but refused to consider this as evidence of alignment of interests because it was not included in the complaint. *Aronson*, 473 A.2d at 810.

42. *Id.* at 809.

43. *Id.* at 818.

which demand futility is addressed by the courts in the cases in the sample. It shows that out of the 124 cases in the sample, motions to dismiss the complaint on the grounds for failure to satisfy the demand requirement are made in about thirty percent of the cases.⁴⁴

If we sort these data into Delaware cases and non-Delaware cases, we can see some further results. First, in Delaware, the Supreme Court's decision in *Aronson v. Lewis* appears to have caused a change in the frequency with which defendants raise this issue. Prior to *Aronson*, defendants made these motions in roughly the same percentage of cases in Delaware (fourteen percent) and outside of Delaware (eighteen percent).⁴⁵ After *Aronson*, the situation changed dramatically. Motions to dismiss for failure to make demand were raised in seventy-five percent of the Delaware cases decided after *Aronson*, compared to only fourteen percent of the Delaware cases prior to that decision. Moreover, comparing Delaware and non-Delaware cases after *Aronson*, we find that these motions were made in only twenty-four percent of non-Delaware cases versus seventy-five percent of the Delaware cases. Both of these differences are statistically significant at less than the one percent level of significance.⁴⁶

Obviously, *Aronson* has had an impact on motion practice in Delaware, which is not surprising given the precedential significance of the decision to the Delaware Court of Chancery. What is somewhat surprising is its lack of impact in other jurisdictions. Delaware corporate law is often said to affect how other jurisdictions deal with corporate cases. It seems quite plausible that defense counsel would try to use *Aronson* as a basis for filing motions to dismiss for failure to show demand futility no matter where the case is brought.

One possible explanation for this difference is the adoption by seventeen states over the past thirteen years of the Model Business Corporation Act's (MBCA) universal demand requirement.⁴⁷ This requirement forces plaintiffs

44. We do not separately discuss in the text cases where the plaintiff made demand on the board to take action. However, there were only two cases in our sample where the plaintiffs made such a demand. In one of these cases, the court found that the board had wrongfully refused demand and permitted the plaintiff to pursue his case, while in the other case, the court found just the opposite.

45. Using the Fisher exact test, we find that the difference between these cells in the table is statistically insignificant. For further discussion of the Fisher exact test, see 2 M. KENDALL & A. STUART, *THE ADVANCED THEORY OF STATISTICS* 580-85.

46. In comparing Delaware cases pre- and post-*Aronson*, we find a Chi-Square statistic of 16.588 (p-value = 0.001). The post-*Aronson* comparison of Delaware and non-Delaware cases generates a Chi-Square statistic of 13.632 (p-value = 0.001).

47. See ARIZ. REV. STAT. ANN. § 10-742 (West 2000) (effective 1996); CONN. GEN. STAT. ANN. § 33-722 (West 2000) (effective 1997); GA. CODE ANN. § 14-2-742 (2000) (effective 1988); HAW. REV. STAT. ANN. § 414-173 (Michie 2000) (effective 2001); IDAHO CODE § 30-1-742 (Michie 2000) (effective 1998); ME. REV. STAT. ANN. tit. 13-A, § 630 (West 1999) (effective 1997); MICH. COMP.

to make a demand on the board of directors prior to filing a derivative action.⁴⁸ Any dispute about the futility of demand from the litigation is eliminated, and, therefore wipes out all motions to dismiss for failure to make demand in cases originating in these jurisdictions. In other words, we will not see motions to dismiss for failure to make demand in cases coming out of these jurisdictions.

However, the adoption of the universal demand requirement in these states is probably not a complete explanation of the difference between Delaware and other jurisdictions on the frequency of these motions. Most of these states are relatively small producers of corporate case law. Thus, there are only six cases in our sample for any of the adopting states, and all six of them originated prior to the adoption of the rule in those states. While we cannot say how many additional cases would have been included in our sample if these states had not adopted the MBCA universal demand requirement, it seems likely it would have been a very small number.

In Table 2, we study the outcome of these motions to dismiss for lack of failure to make demand. Once again, we split our sample into Delaware and non-Delaware cases, and into pre-and post-*Aronson* decisions. We find that, on average, plaintiffs succeed in defeating these motions about forty-one percent of the time in the total sample, with slightly (but insignificantly) higher success rates in non-Delaware cases (forty-four percent) than in Delaware cases (thirty-eight percent). If we break the sample into pre-versus post-*Aronson* statistics, we see some potentially interesting results emerge. For the Delaware sample, we find that there is an increase in the percentage of these motions that plaintiffs win after *Aronson*, with a thirty-three percent success rate before that case, and a thirty-nine percent success rate after that decision. Although this difference is statistically insignificant, it does suggest that while *Aronson* has increased the likelihood of a defense motion to dismiss on demand futility grounds, it has not raised the likelihood of success for such motions. In the non-Delaware cases, we observe the opposite trend after *Aronson*, with a statistically insignificant decrease in the plaintiff's likelihood of success in overcoming a motion to dismiss on demand futility grounds.

LAWS ANN. § 450.1493a (West 2000) (effective 1989); MISS. CODE ANN. § 79-4-7.42 (1999) (effective 1993); MONT. CODE ANN. § 35-1-543 (2000) (effective 1991); NEB. REV. STAT. § 21-2072 (2000) (effective 1995); N.H. REV. STAT. ANN. § 293-A:7.42 (2000) (effective 1993); N.C. GEN. STAT. § 55-7-42 (2000) (effective 1995); TEX. BUS. CORP. ACT ANN. art. 5.14C (Vernon 1980) (effective 1973); UTAH CODE ANN. § 16-10a-740(3) (2000) (effective 1992); VA. CODE ANN. § 13.1-672.1(B) (Michie 2000) (effective 1992); WIS. STAT. ANN. § 180.0742 (West 2000) (effective 1991); WYO. STAT. ANN. § 17-16-742 (Michie 2000) (effective 1997).

48. MODEL BUS. CORP. ACT § 7.92 (2000).

B. *Duty of Care and Waste*

In those cases where the plaintiff can survive the procedural hurdles, suits challenging compensation practices still face important substantive hurdles. The courts have been very exacting about what plaintiffs must prove in order to win these cases. In this section, we examine the difficulties facing shareholders that bring two common types of legal claims made in executive compensation suits: breach of the duty of care (procedural due care) and waste (substantive due care).⁴⁹

Claims of a breach of the duty of care attack the procedures that a board has used, and the information that the board has considered, in making its decision about the challenged executive compensation package. To satisfy the duty of care's informational requirements, the "directors must consider all material information reasonably available" to them.⁵⁰ To meet its procedural burdens, the board should put forth "that degree of skill, diligence, and care that a reasonably prudent person would exercise in similar circumstances."⁵¹ The plaintiff will have the burden of proof to establish that the directors were grossly negligent in satisfying these duties.

In Tables 3 and 4, we present data about the plaintiff's success in bringing duty of care claims. We should note that these data represent the outcomes from several different stages of the litigation, including motions to dismiss, motions for summary judgment, trial outcomes and appeal outcomes. We are defining success here to include five different types of events: (1) plaintiff's success against a defendant's motion to dismiss for failure to make demand, (2) plaintiff's success against a motion to dismiss for failure to state a claim, (3) plaintiff's success against a defendant's motion for summary judgment, (4) plaintiff's victory in the trial court, or (5) plaintiff's victory on appeal.⁵²

49. While the courts have treated these claims as if they are separable, it is worth noting that there is a close relationship between determining whether the board's processes are defective and determining whether they produced a rational result. In other words, one is unlikely to find a serious enough process violation to warrant a finding of gross negligence unless that violation resulted in a bad decision.

50. *Brehm*, 746 A.2d at 259 ("The Board is responsible for considering only *material* facts that are *reasonably available*, not those that are immaterial or out of the Board's reasonable reach.").

51. ROBERT CHARLES CLARK, CORPORATE LAW 123 (1986).

52. Our justification for choosing this definition of success, rather than focusing solely on only final victories in the litigation, is two-fold. First, success at an early stage in litigation will often result in a favorable settlement of the case for the plaintiff. Thus, excluding early victories from the sample would have the effect of grossly understating plaintiffs' success rates in these cases. Furthermore, in Part II.D below, we break our sample into the various stages of litigation to see how plaintiffs fare as they move further into the case.

Second, we are limited in the types of issues we can address with the sample that we have. While we would like to be able to examine questions such as, "Do courts treat duty of care claims differently

In Table 3, we see that the overall success rate for plaintiffs bringing duty of care claims is thirty percent for the cases in our sample. These percentages are approximately equal for Delaware (twenty-seven percent) and non-Delaware (thirty-three percent) cases, with the difference being statistically insignificant. We also try to determine if the Delaware Supreme Court's decision in *Smith v. Van Gorkom*⁵³ impacted success rates on duty of care claims. For the Delaware cases in the sample, we see a big jump in the plaintiffs' success rate from zero percent for pre-*Van Gorkom* cases to thirty-three percent for post-*Van Gorkom* cases, but this change is statistically insignificant. For non-Delaware cases, we see the opposite trend with success rates declining in recent years, although again the change is not statistically significant.

Table 4 breaks the duty of care sample into public versus closely held corporation cases. We find that plaintiffs are more successful at closely held corporations than at public companies, although these differences are statistically insignificant.

We turn next to waste claims. Waste is frequently said to be a difficult claim to support in executive compensation cases. If the executive has not participated in fixing the amount of her compensation, and the content of the pay package is approved in good faith by directors who have no financial interest in it, then a reviewing court usually will not examine the fairness or reasonableness of the compensation.⁵⁴ Given the fact that most public corporations use compensation committees comprised exclusively of outside directors to establish executive compensation plans, these board decisions may be effectively immune from judicial review unless a shareholder can show that they constitute a waste of corporate assets.⁵⁵ To win a waste claim,

on a motion for summary judgment than when they go to trial?," our relatively small sample size constrains our ability to do so. Nevertheless, we believe that some interesting information can be gleaned about the courts' treatment of certain types of substantive claims by looking at their overall disposition of them.

53. *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).

54. COX, CORPORATIONS, *supra* note 31, § 11.5. This leading treatise states:

In an attack on allegedly exorbitant compensation, the scope of [judicial] review depends on whether the recipient officers or directors have participated in fixing the compensation. Where the person compensated does not fix the compensation and the amount is set by directors without any adverse interest or influence that would prevent the exercise of a fair judgment, judicial review is very limited. It is considered outside the proper judicial function to go into the business question of the fairness or reasonableness of the compensation as determined by the board of directors. In contrast, if there is self-dealing because the directors stand to gain from their actions, the business judgment rule is not available, and the burden shifts to those receiving the compensation to show good faith and overall fairness to the corporation.

Id. (footnotes omitted).

55. The waste doctrine holds that directors cannot give away corporate assets without any

the shareholder must demonstrate that the company failed to receive even minimal consideration for the compensation awarded.⁵⁶

Tables 5 and 6 present our results. In Table 5, we explore plaintiffs' success rate for waste claims. As with the duty of care sample, we define success as defeating a motion to dismiss for failure to make demand, a motion to dismiss for failure to state a claim, or a motion for summary judgment, or prevailing at trial or on appeal. We find that waste claims are the most frequently made claims in our sample with waste being raised in ninety-seven of our 124 cases. By comparison, duty of care claims were raised in only twenty of the cases in the sample, and duty of loyalty claims appear in eighty-two of our cases.

Plaintiffs succeed overall about forty percent of the time that these claims are brought.⁵⁷ If we compare the likelihood of success for claims made in Delaware cases versus non-Delaware cases, we find that plaintiffs succeed about forty-five percent of the time in non-Delaware cases versus twenty-nine percent of time in Delaware cases, with the difference almost statistically significant.⁵⁸ Splitting the sample between public corporations and close corporations, we see higher success rates for close corporations (forty-nine percent) than in public companies (thirty-two percent). These differences are statistically significant.⁵⁹

In Table 6, we investigate a different aspect of these claims. Here we examine whether waste claims are, as some assert, simply filler claims—tossed into a complaint challenging executive compensation along with duty of loyalty claims or duty of care claims largely to help the plaintiff gain

consideration. See *In re Walt Disney Co. Derivative Litig.*, 731 A.2d 342, 362-63 (Del. Ch. 1998) (“Under well-settled Delaware law, directors are only liable for waste when they ‘authorize an exchange that is so one sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration.’”) (quoting *Glazer v. Zapata Corp.*, 658 A.2d 176, 183 (Del. Ch. 1993)). See also *Sullivan v. Hammer*, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,415, at 97,065 (Del. Ch. Aug. 7, 1990) (“While there is a limit to executive compensation, courts have always been hesitant to substitute their judgment for the directors in ascertaining whether executive compensation is rational.”).

56. Joshua A. Kreinberg, Note, *Reaching Beyond Performance Compensation in Attempts to Own the Corporate Executive*, 45 DUKE L.J. 138, 170-71 (1995). The slightest benefit is sufficient, such as “if the board purports to award the compensation payments for an appropriate purpose such as to reward and retain the executives.” *Id.* at 171.

57. This relatively high success rate may be a reflection of the fact that it is difficult to knock out a waste claim prior to trial. See, e.g., *Michelson v. Duncan*, 407 A.2d 211, 223 (Del. 1979) (“Claims of gift or waste of corporate assets are seldom subject to disposition by summary judgment.”). Compare *Lewis v. Vogelstein*, 699 A.2d 327, 338-39 (Del. Ch. 1997) (stating that some waste claims can be eliminated on a motion to dismiss), with *Harbor Fin. Partners v. Huizenga*, 751 A.2d 879, 901-02 (Del. Ch. 1999) (criticizing this result).

58. The Chi-Square statistic is 2.537 (p-value = 0.111).

59. The Chi-Square statistic is 2.891 (p-value = 0.089).

discovery. Those waste claims often allegedly rise or fall with the success of the other claims in the complaint. In our data set, we see a somewhat different picture emerge. Looking first at the top row of Table 6, we see that seventy-one percent of the time when waste succeeds, at least one other claim succeeds as well. By contrast, in row two of Table 6, we find that waste, either when alleged with other claims or simply by itself, is the only successful claim in sixteen out of eighty-nine instances. When we break down the figures further, we find that plaintiffs succeed on waste claims alone in fifteen percent of Delaware cases and twenty percent of non-Delaware cases. Both of these figures are statistically significantly different from zero at the one percent level of significance. This shows that plaintiffs do succeed with waste claims even in the absence of other successful allegations.

C. Duty of Loyalty

The duty of loyalty requires directors to act in the best interests of the corporation and to refrain from conduct that might injure the company and its shareholders. Where board members have a personal financial interest in a transaction, and vote to approve it, this action creates a taint of conflict of interest. This taint must either be removed through appropriate ratification by a disinterested decision maker, or the directors bear the burden of demonstrating that the transaction is entirely fair to the corporation. Empirical studies have found significant negative stock price reactions to the filing of derivative law suits alleging breaches of the duty of loyalty by boards of directors.⁶⁰

In publicly held corporations, most executive compensation agreements are negotiated between managers and the board's compensation committee. This committee is comprised mostly, if not entirely, of disinterested outside directors. Its decision cannot generally be attacked on duty of loyalty grounds.

However, at many close corporations and a few public companies, the officers set their own pay by virtue of their dual positions as directors. In any instance "when the recipient's vote is essential to the grant of compensation,

60. Stephen P. Ferris et al., *Derivative Lawsuits as a Corporate Governance Mechanism: Empirical Evidence on Board Changes Surrounding Filings* 21 (Oct. 2000) (working paper, on file with authors). This study also found no significant stock price impact for suits alleging breaches of the duty of care. Cf. Daniel R. Fischel & Michael Bradley, *The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis*, 71 CORNELL L. REV. 261, 281 (1986) (finding that judicial rulings on motions to dismiss in duty of loyalty cases had insignificant wealth effects).

the recipient has the burden to prove its reasonableness.”⁶¹ If no disinterested shareholder approval is obtained, the executive must show that the amounts received are reasonable. In making this determination, courts look at the following factors:

evidence of the compensation received by similarly situated executives, the ability of the executive, whether the Internal Revenue Service has allowed the corporation to deduct the amount of salary alleged to be unreasonable, whether the salary bears a reasonable relation to the success of the corporation, the salary history of the executive, the relation of increases in salary to increases in the value of services rendered, and the relation of the challenged salary to other salaries paid by the employer.⁶²

This discussion leads us to expect that plaintiffs are more likely to be successful in bringing duty of loyalty claims in executive compensation cases at closely held companies. This hypothesis is supported by the data that are presented in Table 7. As with waste and duty of care claims, we again define success as defeating a motion to dismiss for failure to make demand, a motion to dismiss for failure to state a claim, or a motion for summary judgment, or victory at trial or on appeal.

Looking first at the totals column, we find that plaintiffs are more successful at closely held companies (fifty-three percent) than at public corporations (fifteen percent). This difference is statistically significant.⁶³ To examine this result more closely, we next looked to see if there was a difference between how Delaware courts treat duty of loyalty claims and how courts in other states treat them. We found that for non-Delaware cases, loyalty claims succeeded in only five percent of the public corporations, whereas in closely held companies the success rate was fifty-six percent. This difference is also statistically significant.⁶⁴ However, for Delaware cases, the difference in the plaintiffs’ success rates are smaller and statistically insignificant: public corporations (twenty-five percent) versus close corporations (forty-three percent). When we compare plaintiffs’ success rates on all duty of loyalty claims in Delaware (thirty percent) with those in non-Delaware cases (thirty-eight percent), we find the difference statistically insignificant.

61. RODMAN WARD, JR. ET AL., *FOLK ON THE DELAWARE GENERAL CORPORATION LAW* § 122 (4th ed. 1999) (general comments about § 122(5)).

62. *Id.*

63. The Chi-Square statistic is 12.99 (p-value = 0.001).

64. The Chi-Square statistic is 9.107 (p-value: 0.003).

D. Closely Held Versus Publicly Held Corporations

As discussed previously, there are good reasons to believe that executive compensation decisions at closely held corporations are more susceptible to attack than those at public corporations. One obvious reason is that directors at closely held corporations are more likely to pass on their own compensation, thereby creating a conflict of interest claim for unhappy shareholders, whereas at public corporations, compensation committees are generally comprised of disinterested outside directors whose decisions are free of that particular taint. Less obviously, public corporations tend to be more careful in observing the procedural formalities necessary for compliance with directors' duty of care. Boards act on a more formal basis in comparison to closely held companies, where the directors may all be active in the business and more familiar with one another. Furthermore, it seems likely that shareholders challenging compensation decisions at close corporations may have more information about the actions of the board—as they are usually more involved in the business and have a larger percentage of ownership—than shareholders of public corporations, who often know nothing more about the business than what is contained in the company's filings for the Securities Exchange Commission (SEC), and who may hold a very small percentage of the stock. Finally, executive compensation tends to be a much larger percentage of the profits of a closely held corporation than at publicly held companies. This difference makes it a much more important issue for nonemployee shareholders, who are most likely to challenge pay packages.

The close corporation cases frequently involve substantive review of the fairness of executive pay. These companies rarely employ independent outside directors on compensation committees, which results in officers who are usually directly involved in setting their own pay. Thus, if a compensation package is challenged by a disgruntled minority shareholder, the transaction is tainted with a conflict of interest, thereby leading courts to apply the entire fairness test. This test places the burden on the board to show that the amounts paid are reasonable by producing evidence, such as, the level of compensation at comparable companies, the job performance of the executives, and other data bearing on what similar individuals are paid for similar duties elsewhere. For all of these reasons, we expect to see that plaintiffs challenging executive compensation decisions at companies in our sample are more successful at close corporations than they are at public companies.

In Table 8, we explore this question in our examination of court decisions at each stage of the litigation. We first calculate the success rates for

plaintiffs for each type of motion, trial, and appeal in our sample. We find that plaintiffs' success rates at these different stages of the litigation vary substantially: motions to dismiss for failure to make demand (forty-two percent); motions to dismiss for failure to state a claim (twenty-six percent); motions for summary judgment (twenty-eight percent); trials (thirty-nine percent); and appeals (thirty-nine percent). It is difficult to draw strong conclusions from these numbers. At one extreme, if we assume that plaintiffs are forced to go through every one of these stages of litigation, and win the average percentage of the time at each stage, then the odds of successfully prosecuting an executive compensation case are extremely small (0.0052 percent).

However, this estimate clearly overstates the hurdles that plaintiffs face for at least two reasons. First, not all plaintiffs have to overcome each barrier: some defendants may not appeal losses at trial, other defendants may not engage in motions practice to the fullest (or any) extent, and so forth. Second, as we noted earlier, plaintiffs that succeed in overcoming the initial defense motions will often settle their cases on favorable terms. In other words, a successful plaintiff will often end their case well before trial or appeal.

If we examine the data further, we find that plaintiffs do consistently better in closely held corporations than in public corporations. For example, plaintiffs succeed much more frequently on motions to dismiss for failure to make demand at close corporations (sixty-two percent) than at public corporations (thirty percent), a statistically significant result.⁶⁵ We find a similar pattern at each stage of the litigation, although the statistical significance disappears. This result is consistent with our earlier claims that directors at close corporations are more likely to suffer from conflicts of interest and use fewer procedural safeguards, while plaintiffs in these companies are more likely to have access to inside information without the benefit of discovery.

E. Delaware Versus Non-Delaware Cases

Table 9 summarizes some of the data that we presented earlier showing plaintiffs' success rates in Delaware versus non-Delaware cases. It illustrates that plaintiffs have higher rates of success in the executive compensation cases in our sample in non-Delaware cases, than in Delaware cases for each type of substantive claim. While only the differences with respect to waste claims are statistically significant, taken as a whole, the results appear to

65. The Chi-Square statistic is 3.306 (p-value = 0.069).

show a consistent pattern of relative judicial hostility by the Delaware courts to compensation cases.

If we look further at the underlying data in Tables 4, 5 and 7, we see that one potential explanation for these results is that the Delaware courts' caseload includes a much higher percentage of cases involving public corporations than those of other courts. From Table 4, we see that for duty of care claims, seventy-three percent of the Delaware cases involve public companies, whereas only fifty-five percent of non-Delaware cases do. For waste claims, these differences are even bigger: eighty-two percent of Delaware cases concern public corporations versus thirty-five percent of non-Delaware cases. Similarly, with duty of loyalty cases, we see seventy-four percent of the Delaware cases being brought against public companies, but only thirty-five percent of non-Delaware cases involve public corporations. The disproportionate number of cases involving public corporations that are in our Delaware sample most likely stems from the fact that about fifty percent of all American public corporations are incorporated in Delaware, whereas only five percent of the close corporations in the United States are incorporated there.⁶⁶

To explore this result, we compare success rates in Delaware and non-Delaware cases for public and closely held corporations. In Table 10, we present aggregate data for our sample where we calculate the plaintiffs' success rate on any claim divided by the total number of cases for Delaware and non-Delaware cases. The two sets of courts are surprisingly similar in the way that they treat these claims. In both instances, plaintiffs win around one-third of the time in claims involving public corporations, and one-half the time in claims brought against close corporations. In examining the difference between success rates for public corporations and close corporations, we find that plaintiffs' success rates in non-Delaware courts are statistically significantly higher for close corporation claims, whereas in Delaware courts the difference is higher but statistically insignificant.

In Table 11 we present the results of a logit analysis of our data which confirms these findings. Our dependent variable is PWINS, or "plaintiff wins on any claim in the case." Equation 1 shows that the dummy variable PUBLIC is negatively and significantly associated with success rates, but that the DELWRE variable is insignificant. In equation 2, we break out the data more finely, but see similar results. The only significant variables are the dummy variables for Delaware public corporations (DELPUBLIC) and non-

66. Marcel Kahan & Ehud Kamar, Price Discrimination in the Market for Corporate Law 6 (2000) (working paper, on file with authors).

Delaware public corporations (NONDELPUBLIC). Both have the expected negative sign.

F. Shareholder Ratification

Another important aspect of compensation cases is the presence or absence of effective shareholder ratification. If the company seeks a shareholder vote concerning whatever action the board of directors has taken after fully disclosing all material information concerning the action, and a majority of the shareholders approves the board's actions, this action will insulate the directors from certain types of legal claims. Although there is some variation among the states over the precise implications of effective shareholder ratification, generally speaking, it makes it extremely difficult for a plaintiff to succeed on a duty of care or duty of loyalty claims. Waste claims, on the other hand, are unaffected by shareholder ratification because only a unanimous shareholder vote will ratify corporate waste.

From the plaintiff's perspective, they must contest the effectiveness of shareholder ratification if there is a favorable shareholder vote on the contested board action. The best way for the plaintiff to do so is to argue that some piece of material information was not disclosed to the shareholders, and therefore the vote has no impact. In our data set, we have thirty-one cases where the plaintiffs have contested the effectiveness of a shareholder vote ratifying the board's actions.

Table 12 presents this data. We divide the sample into Delaware versus non-Delaware cases, and cases where the court found shareholder ratification effective versus those where it did not. The results show that in situations where courts found shareholder ratification was effective, the plaintiffs succeeded less than ten percent of the time (the two successes were with waste claims). However, in cases where the courts found the ratification was ineffective, the plaintiffs succeeded in all of them. The difference between the plaintiffs' success rates are highly significant.

One possible interpretation of these results is that plaintiffs almost always lose when there is full disclosure and a shareholder vote ratifying the transaction. Another possible interpretation is that when courts believe that the plaintiffs' claims are strong, they are more likely to find that the company has failed to disclose all material facts to its shareholders and therefore ratification is ineffective. Conversely, if the court believes the plaintiffs' case is weak, it concludes that all material information has been disclosed and throws the case out.

G. The Fifty Percent Hypothesis

Having now laid out all of the empirical results in the study, we want to return to our earlier discussion of the Priest-Klein fifty-percent hypothesis. There is a clear divergence in our results between plaintiffs' success rates in compensation litigation against public corporations and close corporations. As we saw in Table 10, plaintiffs in close corporation claims win about fifty percent of the time in both Delaware and non-Delaware cases. By contrast, the success rates in public corporation claims are around thirty percent. Our interpretation of these results is that plaintiffs are more likely to succeed in executive litigation brought against close corporations than they are in similar cases filed against public companies.

Is there an alternative explanation of these differences using the Priest-Klein fifty percent hypothesis? First, we should point out that our results concern success at each stage of litigation, not ultimate success in the case. However, if each stage of litigation involves an independent decision to continue, we should see the parties making discrete choices about their likelihood of success. Second, we note that these cases should be appropriate for analysis using this model. The underlying substantive and procedural claims in both sets of cases are identical. The law in this area is well-settled so that it should be possible for the litigants to accurately assess their chances of prevailing on their claims. Delaware courts are renowned for their focus on certainty and consistency in adjudicating corporate disputes. All of these factors would lead us to believe that if the fifty percent hypothesis is correct, the success rates of plaintiffs in compensation cases should be fifty percent across the board. The statistically significant difference between plaintiffs' success rates in close corporation suits and public corporation suits suggests that the Priest-Klein model does not explain our results.

However, as we noted earlier though, Kessler, Meites, and Miller have identified two effects which may differentially impact plaintiffs' chances of success in these cases.⁶⁷ The first effect is the difference between the size of the stakes in litigation at public and closely held companies.⁶⁸ While we lack data to attach values to such differences, we believe that, in general,

67. Kessler et al., *supra* note 26.

68. As Kessler, Meites, and Miller explain:

[T]he party with larger stakes has more to lose from the litigation and therefore is likely to offer enough to settle the case, from the perspective of the party with a lesser stake, in order to avoid a larger loss at trial. Thus the cases that are selected for trial are likely to be ones in which the party with the greater stakes has a relatively better chance for success than would be the case when the stakes are equal.

Id. at 242.

compensation cases filed against public corporations will involve higher stakes than similar cases at close corporations. This difference should arise from a variety of factors. For example, the dollar amounts for executive pay are usually bigger at public companies than at close companies. Furthermore, an adverse judgment may have a larger impact on a public company's reputation, or standing within the financial community. If these differences exist, then Kessler, Meites and Miller's analysis suggests that they will lead public companies more frequently to offer enough to settle the litigation, thereby resulting in cases being selected for trial that have a relatively low success rate.⁶⁹ This situation would result in lower observed success rates in cases involving public corporations, which would be consistent with our results.

Agency costs, the second effect identified by Kessler, Meites and Miller, arise out of the method by which the attorneys litigating these cases are paid—hourly fees versus contingent fees—and who controls the litigation.⁷⁰ With respect to how the attorneys in these cases are paid, we again lack hard information on which to base our analysis, but we believe that it is likely that many compensation cases brought against public corporations are handled by attorneys on a contingent fee basis, whereas pay cases involving close corporations are more likely to be litigated on a hourly fee basis. The rationale behind this assertion is based on an author's personal experience in litigating these cases and the observation that there is a far greater potential fee for representing a large class of shareholders in a public corporation case than in a close corporation case. The potential to represent a large class of shareholders makes it potentially more attractive for the attorney to take a public company case on a contingent fee basis. Kessler, Meites and Miller claim that this can result in a downward bias in plaintiff's success rates in close corporation cases.⁷¹

However, in determining the overall effects of agency costs, we also need to take into account whether the client controls the litigation. We would expect that the clients in close corporation cases would have much greater control over the conduct of the litigation than the investors named as

69. *Id.*

70. Kessler, Meites, and Miller hypothesize that there will be two aspects to the agency costs analysis. They first ask if the attorneys are paid on an hourly basis or on a contingent fee basis, claiming that attorneys on a hourly fee are more likely to prolong litigation to increase their fees, whereas lawyers on a contingent fee contract will want to settle early. The second step of their analysis asks if the client controls the decision to litigate. If so, then the client will be likely to litigate more fully contingent fee cases than hourly fee cases because the client does not bear the full costs of more litigation in a contingent fee arrangement. *Id.* at 246-48.

71. *Id.* at 248.

plaintiffs in the public corporation cases. Here, we believe that investors in close corporations are more likely to be intimately involved in their cases because, among other things, they frequently arise out of personal disputes between nonemployee minority investors and employee majority shareholders. Public corporation shareholders are much less likely to have such a personal stake in their litigation; therefore, we would expect their attorneys to exert more control in these cases. In short, we believe that attorneys are more likely to control public corporation cases, whereas clients are more likely to control close corporation cases. Kessler, Meites and Miller claim that when “attorneys control the decision to litigate, then contingency fee contracts should be associated with a higher probability of plaintiff victory.”⁷² In sum, the agency costs analysis should lead us to predict a higher observed level of plaintiffs’ success rates for the public corporation cases than in close corporation cases.

If we are correct in our factual assertions, the net effect of differential stakes and agency costs on plaintiffs’ success rates in compensation cases is indeterminate. The differential stakes analysis leads us to believe that public company litigation should have a lower observed success rate. However, attorneys’ control over the decision to litigate in the contingency fee cases brought at public corporations should lead to higher rates of success for public company cases. We cannot be sure which effect will be stronger and therefore cannot rely on them as a satisfactory explanation of the observed patterns in our data.

Another potential explanation of our results could arise if there are a significant number of strike suits—cases with little merit that are filed solely to obtain a cheap settlement—brought against public corporations, but not against close corporations. If we assume that this may be the case, and we further hypothesize that public corporations either refuse to settle these cases, or settle them prior to filing a motion to dismiss the case, then we would expect the observed success rates for plaintiffs’ bringing actions against public corporations to be lower than for close corporations. Unfortunately, we do not have data to test this theory, although we note that it would allow us to accept both the fifty percent hypothesis and our earlier interpretation of the data.

In conclusion, we would like to reemphasize that many other researchers have been unable to reconcile their analysis of observed patterns in litigated cases with the fifty percent rule. We have examined various possible ways of reconciling our results with the fifty percent hypothesis. We find none of

72. *Id.*

them completely satisfactory, and therefore conclude that our observed differences are likely to reflect real differences in success rates.

III. LEGAL DEVELOPMENTS POTENTIALLY AFFECTING JUDICIAL REVIEW OF EXECUTIVE PAY

Are there any recent developments that may increase the likelihood that plaintiffs will be successful in executive compensation litigation? In this Part, we look at two potential changes in corporate law that could impact shareholder litigation over executive compensation: the ALI Principles of Corporate Governance Project and the Delaware Supreme Court's recent decision in *Brehm v. Eisner*.⁷³

A. *The American Law Institute (ALI) Principles of Corporate Governance*

The American Law Institute's Principles of Corporate Governance project addressed the appropriate standards for judicial review of executive compensation decisions.⁷⁴ The ALI Principles accept the proposition that corporate law should be more deferential to a board's compensation decisions than other types of self-interested conduct.⁷⁵ They offer three justifications for this approach: first, that "compensation arrangements with directors and senior executives are necessary in all cases;" second, that many compensation packages are recurring and widely publicized making it easy to draw comparisons between them and deterring overreaching; and third, that institutional procedures practiced by large public companies reduce the chance of corporations being disadvantaged by compensation arrangements which are unfair.⁷⁶

Substantively, the ALI Principles do not urge courts to make big changes in the way that they treat executive compensation decisions. They provide that interested directors or managers who receive compensation from the company may satisfy the duty of fair dealing by meeting any one of four

73. *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000).

74. AM. LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 5.03 (1994) [hereinafter ALI PRINCIPLES]. See also James D. Cox, *The ALI, Institutionalization, and Disclosure: The Quest for the Outside Director's Spine*, 61 GEO. WASH. L. REV. 1233, 1247 (1993).

75. The comments explain the rationale for applying "less intense scrutiny" in situations where compensation is involved than they would in other cases of self-interested transactions covered by section 5.02 (which requires, in part, that the self-interested transaction be disclosed to the corporate decision maker). ALI PRINCIPLES, *supra* note 74, § 5.03, cmt. C.

76. *Id.* (pointing out that it is "good corporate practice" to have a disinterested compensation committees "to review and approve compensation arrangements").

conditions discussed in the accompanying note.⁷⁷ Section 5.03 allows for disinterested director approval of proposed compensation transactions but requires a stronger showing for after the fact ratifications by disinterested directors of the same pay packages.⁷⁸ “Absent disinterested-director approval, the only other options are the more cumbersome and expensive process of obtaining shareholder approval and the less predictable burden of proving fairness to the corporation.”⁷⁹

However, when they address the procedural hurdles for shareholder litigation, the ALI Principles make life more difficult for shareholder plaintiffs attacking executive compensation.⁸⁰ As noted in Part II.A, under Delaware law, shareholders must make a demand on the board to prosecute the action or take corrective measures, or allege that such a demand would be futile.⁸¹ To establish that demand is futile, shareholders must generally show facts that create a doubt that the board acted disinterestedly.

The ALI Principles, however, chose to mimic the approach taken in the MBCA, and require demand in every case unless it will cause irreparable injury to the corporation.⁸² This requirement shifts the judicial inquiry about the merits of the plaintiff’s complaint to a motion to dismiss for failure to

77. ALI PRINCIPLES, *supra* note 74, § 5.03(a). These four conditions are as follows: (1) if “[t]he compensation is fair to the corporation when approved, *id.* § 5.03(a)(1); (2) if “[t]he compensation is authorized in advance by disinterested directors” or, if the compensation involves a senior executive who is not a director, “by a disinterested superior, in a manner that satisfies the standards of the business judgment rule,” *id.* § 5.03(a)(2); (3) if “[t]he compensation is ratified by disinterested directors . . . who satisfy the requirements of the business judgment rule” if (i) a disinterested corporate decision maker acted for the corporation and satisfied the business judgment rule, (ii) “the interested director or senior executive did not act unreasonably in failing to seek advance authorization . . . by disinterested directors or a disinterested superior; and (iii) the failure to obtain advance authorization . . . did not adversely affect” the corporation’s interests, *id.* § 5.03(a)(3); and (4) if “[t]he compensation is authorized in advance or ratified by disinterested shareholders” and is not a waste of the corporate assets. *Id.* § 5.03(a)(4).

78. Professor Cox argues that this heightened requirement stems from the fact that outside directors are less likely to be independent when faced with a “done deal.” Cox, *supra* note 74, at 1252 (describing the difference between approvals of proposals and ratifications under section 5.02, which has the same language in this regard as section 5.03).

79. Cox, *supra* note 74, at 1248. If the compensation package is not approved by disinterested directors or shareholders, the proposals state that the burden is on the interested party to prove that the compensation is fair. ALI PRINCIPLES, *supra* note 74, § 5.03(b). *See also* Cox, *supra* note 74, at 1247.

80. *See* Cox, *supra* note 74, at 1249 (criticizing this approach and stating that “[a]ny improvements in the substantive treatment of overreaching conduct are eviscerated by the ALI’s conservative treatment of the derivative suit”).

81. COX, CORPORATIONS, *supra* note 31, § 15.7.

82. ALI PRINCIPLES, *supra* note 74, § 7.03(b). *See* MOD. BUS. CORP. ACT § 7.42 (1999). This “universal demand” requirement essentially shifts the pretrial battle to the board. Cox, *supra* note 74, at 1250 (pointing out that the ALI has made “the profound choice to regularize the process by requiring a formal presentation of the board’s or committee’s belief that continuation of the derivative suit is not in the corporation’s interest”).

state a claim. The ALI principles set forth the standards for judicial review of these claims by differentiating between actions raising duty of care issues and actions alleging violations of the duty of fair dealing.⁸³ In compensation cases raising duty of care and waste claims, section 7.10(a)(1) provides that a decision by a disinterested board to move to dismiss the lawsuit will be protected by the business judgment rule.⁸⁴ This standard of review will undoubtedly bar suits concerning compensation decisions when disinterested directors are uninformed about gross overreaching by executives.⁸⁵ By contrast, for transactions alleging a breach of the duty of fair dealing, such as claims of a breach of the duty of loyalty, courts are urged to scrutinize the boards' actions more closely.⁸⁶

The executive compensation provisions of the ALI Principles have been widely criticized.⁸⁷ For example, Professor John Coffee recently stated that the drafters of the executive compensation provisions were not sufficiently aware of how important executive compensation is in aligning managers' and shareholders' interests.⁸⁸ Others have claimed that board compensation committees have done a poor job meeting the standards set in the ALI Principles by, among other things, not sufficiently tying pay to performance.⁸⁹ In any event, the proposals appear unlikely to increase the success rate of shareholder derivative litigation challenging executive compensation decisions.

83. Compare ALI PRINCIPLES, *supra* note 74, § 7.10(a)(1), with ALI PRINCIPLES, *supra* note 74, § 7.10(a)(2).

84. ALI PRINCIPLES, *supra* note 74, § 7.10(a)(1). See also Cox, *supra* note 74, at 1251 (noting that the ALI's goals are to limit the derivative suit to instances of illegal behavior, unfair dealing, and self-dealing).

85. See Cox, *supra* note 74, at 1253 (arguing that the ALI should have approached the issue "accentuat[ing] the seriousness with which [they] view the outside directors' obligation to respond to overreaching").

86. As Professor Cox has noted, the ALI Principles are more concerned with the nature of the suit than with the interestedness or disinterestedness of the directors. If the suit involves a business decision which would normally be protected by the business judgment rule, the same rule will protect the directors in disfavoring the claim. If, on the other hand, the suit involves activities, such as self-dealing, which are not protected by the business judgment rule, decisions disfavoring the claim will be given less protection. See Cox, *supra* note 74, at 1251 (stating that this distinction is "pure sophistry").

87. See American Law Institute's *Principles Widely Accepted by Boards, Courts*, U.S.L.W., Aug. 25, 1998, at 2105-06 (comments of John C. Coffee Jr. and John T. Subak at the American Bar Association's 1998 Annual Meeting).

88. Coffee was critical of the ALI's relaxed business judgment standard of review. *Id.* at 2106.

89. *Id.*

B. The Delaware Supreme Court's Brehm v. Eisner Decision

The Delaware Supreme Court recently issued a major opinion concerning shareholder challenges to board compensation decisions, *Brehm v. Eisner*.⁹⁰ This decision affirmed a Chancery Court's dismissal of a complaint⁹¹ attacking a decision by the board of the Walt Disney Company (Disney) to pay a departing executive very large severance payments. The Disney board had approved a "Non-Fault Termination" of Michael S. Ovitz, thereby triggering the payment of a ten million dollar lump sum payment, a payment equal to the present value of all his remaining salary payments for the term of his employment contract, an additional payment equal to "the product of \$7.5 million times the number of fiscal years remaining under the [employment] Agreement (i.e., Ovitz's approximate forgone bonuses)," and the immediate vesting of three million stock options for Disney shares.⁹² The Chancellor granted with prejudice the defendants' motion to dismiss the complaint for failure to plead demand futility and failure to state a claim.

The Delaware Supreme Court began by reviewing de novo the allegations of the complaint that demand on the board was futile.⁹³ Applying the *Aronson* test for establishing demand futility, the Court looked to see if the plaintiffs had made an adequate claim either that a majority of the board was interested in the transaction, or that the board's decision was not the product of a valid exercise of business judgment.⁹⁴

The Court rejected the plaintiffs' argument that the majority of the board was interested in the transaction, principally focusing on the claim that Michael D. Eisner, the CEO of Disney, was interested in the transaction and that he dominated and controlled the board of Disney to such an extent that the directors could not exercise independent business judgment.⁹⁵ It affirmed the lower court's dismissal of these claims with prejudice.

The more interesting part of the decision is its analysis of the second *Aronson* prong, that is, whether the board had breached their duty of care or committed waste in approving the termination payments. The complaint alleged that the board was uninformed because the directors did not know the

90. *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000).

91. *In re Walt Disney Co. Derivative Litig.*, 731 A.2d 342 (Del. Ch. 1998). The Supreme Court's dismissal was without prejudice though, thereby giving the plaintiffs an opportunity to file their complaint again.

92. *Id.* at 352.

93. *Brehm*, 746 A.2d at 253-54. In deciding to do so, the court overruled previous cases finding that such review should be deferential to the lower court's findings.

94. *Id.* at 255.

95. *Id.* at 257-58.

value of the Ovitz termination payments when they approved his employment agreement.⁹⁶ It cited subsequent statements made by the board's compensation consultant, Graef Crystal, that he had failed to calculate the value of these payments and wished that he had. The complaint also alleged that the board had committed waste by granting Ovitz a no-fault termination when he had effectively resigned from the company or could have been terminated for cause.

The court's analysis began with the statement:

Pre-suit demand will be excused in a derivative suit only if the Court of Chancery in the first instance, and this Court in its de novo review, conclude that the particularized facts in the complaint create a reasonable doubt that the informational component of the directors' decisionmaking process, measured by concepts of gross negligence, included consideration of all material information reasonably available.⁹⁷

The court found that the size of the termination payments to Ovitz was material information for purposes of the directors' decision making process and was reasonably available to the board of directors.⁹⁸ The court went on to read the complaint as stating that no one had calculated the value of the severance package, including the board and its expert.⁹⁹

However, the court suggested that the question raised by the complaint was whether the directors were protected from liability because of a good faith reliance on a qualified expert. It found that the complaint did not rebut the presumption that the board was entitled to such protection. The Court therefore dismissed the claim, although it permitted the plaintiffs an opportunity to replead it.¹⁰⁰

In regard to the plaintiffs' waste claims, the court reaffirmed that the waste test is satisfied only by "an exchange that is so one sided that no

96. In fact, the complaint included several quoted statements to this effect by Graef Crystal, the financial expert who advised the board about the agreement. *Id.* at 251.

97. *Id.* at 259.

98. *Brehm*, 746 A.2d at 259-60. In an accompanying footnote, the court states that materiality in this context means information that is "relevant and of a magnitude to be important to directors in carrying out their fiduciary duty of care in decisionmaking." *Id.* at 259 n.49.

99. *Id.* at 260.

100. *Id.* at 262. In this regard, the court does provide plaintiffs with a roadmap of the allegations needed to survive a motion to dismiss in a due care case where a board has been advised by an expert. Interestingly, the court includes the possibility that a complaint could allege that "the subject matter (in this case the cost calculation) that was material and reasonably available was so obvious that the board's failure to consider it was grossly negligent regardless of the expert's advice or lack of advice . . ." *Id.* It is unclear why the complaint in this case did not support an allegation of this type on a motion to dismiss where all reasonable inferences are to be drawn in the plaintiffs' favor.

business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration.”¹⁰¹ The Court went on to say that these cases are “confined to unconscionable cases where directors irrationally squander or give away corporate assets.”¹⁰² Construing the complaint, the court found that while it could be read to say that the Disney board could have negotiated a better deal on Ovitz’s termination because of his claimed decision to resign and the Board’s potential grounds for terminating him for cause, this was not sufficient to find that the board had committed waste. Again, the court dismissed the claim without prejudice.¹⁰³

Does the *Brehm* decision open new doors to plaintiffs seeking to challenge compensation packages? The court’s analysis of the informational requirements for the application of the duty of care may be helpful to plaintiffs in some cases. The court’s statements that the very large size of the payouts to Ovitz made them material information to directors would seem to be applicable in challenges to large executive pay packages.¹⁰⁴ Furthermore, the court’s finding that the information was reasonably available to the board if either the compensation consultant, or the directors, could have calculated it, should also make it easier to claim that the board needed to consider this type of information to satisfy the pleading requirements of the duty of care.

However, plaintiffs will rarely be able to plead informational deficiencies in what directors were told concerning a compensation package without the use of discovery. Thus, the court’s discussion of the informational requirements of procedural due process may be of limited use in helping plaintiffs overcome the demand requirement.¹⁰⁵

The remainder of the court’s opinion has little to offer plaintiffs. The court takes pains to point out that should the plaintiffs choose to file an amended complaint, the defendant directors could claim that they relied in good faith on the advice of their expert under the Delaware corporate code.¹⁰⁶ Furthermore, the court’s finding that the plaintiffs had not met the pleading

101. *Id.* at 263 (quoting *In re The Walt Disney Co. Derivative Litig.*, 731 A.2d at 362 (quoting *Glazer v. Zapata Corp.*, 658 A.2d 176, 183 (Del. Ch. 1993))). It agreed with the Chancellor that “the size and structure of executive compensation are inherently matters of judgment.” *Id.*

102. *Id.*

103. It is interesting that the court does not cite any of its earlier cases holding that waste claims are not usually subject to disposition on motions to dismiss. *See Michelson v. Duncan*, 407 A.2d 211, 223 (Del. 1979).

104. *Brehm*, 746 A.2d at 259.

105. For a discussion of the court’s opinion of using the Delaware books and records statute to uncover further evidence of wrongdoing, see *supra* note 36.

106. At public corporations, compensation committees routinely use compensation consultants to advise them on the size and composition of executive pay packages. However, this procedure is less frequently true at closely held companies. As a result, *Brehm* may be more helpful to shareholders at close companies.

requirements for demand futility may indicate some hostility to these cases. Justice Hartnett's concurring opinion is, in essence, a dissent on this basis. He concludes that the plaintiffs ought to be entitled to limited discovery based on the allegations of the complaint.¹⁰⁷ While the majority does give the plaintiffs leave to file an amended complaint, its opinion goes out of its way to warn plaintiffs' counsel that Rule 11 will apply to any amended complaint.¹⁰⁸ It is hard to construe such a warning as encouragement to continue to press the litigation.

Brehm v. Eisner seems to show a hostility by the Delaware Supreme Court to executive compensation claims. Faced with a fact pattern that seems to show an uninformed board approving a very large payment to a departing executive on the thinnest of business justifications, the court would not even allow the plaintiffs to engage in discovery on their claims. While we can only speculate about how another court would have handled the same case, our data suggest that, at least on the waste claim, the plaintiffs might have received better treatment elsewhere.

IV. SHOULD WE HAVE DIFFERENT STANDARDS FOR JUDICIAL REVIEW OF EXECUTIVE COMPENSATION?

A number of commentators have argued that we need stricter standards of judicial review in cases challenging executive compensation in order to reform the executive compensation process.¹⁰⁹ They argue that the existing waste doctrine encourages corporate counsel to delegate all decision making to disinterested directors, to give them plenty of information, and to hire external experts,¹¹⁰ but does push directors to take hard positions in pay negotiations. These critics believe that if corporate counsel were afraid of having the board's decisions seriously reviewed by a court with directors potentially being held personally liable, counsel would advise executives to lower their compensation demands to more defensible levels.¹¹¹ As Professor

107. *Brehm*, 746 A.2d at 267-68.

108. *Id.* at 266.

109. See, e.g., Charles M. Yablon, *Overcompensating: The Corporate Lawyer and Executive Pay*, 92 COLUM. L. REV. 1867, 1899 (1992) (reviewing GRAEF CRYSTAL: IN SEARCH OF EXCESS (1991)) (proposing that courts use an intermediate level of scrutiny in reviewing compensation packages); Detev Vagts, *Challenges to Executive Compensation: For the Markets or the Courts?*, 8 J. CORP. L. 231, 252-61 (1983) (stating that courts should adopt approach used in tax and close corporation cases for testing reasonableness of compensation by comparing compensation levels with those of similar firms); Linda J. Barris, *The Overcompensation Problem: A Collective Approach to Controlling Executive Pay*, 68 IND. L.J. 59 (1992) (same).

110. Yablon, *supra* note 109, at 1897.

111. Yablon, *supra* note 109, at 1897-1900.

Vagts wrote: "If the courts act, even occasionally, to trim compensation it will, in turn, be easier for compensation committees to tell executives that they simply cannot gratify their pocketbooks and egos as much as the executives demand."¹¹²

A number of existing bodies of law could be tapped to provide a stricter standard for judges to apply in executive compensation cases. Different commentators have suggested the reasonableness standard used in tax cases involving close corporation's claims for deductions of executive compensation,¹¹³ and the proportionality test applied by Delaware courts in takeover cases.¹¹⁴ For example, in tax cases, courts have undertaken to understand the complexities of executive compensation plans in close corporations and to determine what constitutes reasonable pay.¹¹⁵ While many appellate courts deciding these cases have used multifactor tests which can be difficult to apply consistently, at least one such court has adopted a "much simpler and more purposive test, the independent investor test."¹¹⁶

The arguments in favor of judicial intervention over executive pay are

112. Vagts, *supra* note 109, at 276.

113. Barris, *supra* note 109, at 87; Vagts, *supra* note 109, at 257-61. *See, e.g.*, *Labelgraphics, Inc. v. Comm'r of Internal Revenue*, 221 F.3d 1091 (9th Cir. 2000) (applying five-factor test to determine if the amount of compensation paid to a corporate executive was reasonable); *Pfeiffer Brewing Co. v. Comm'r of Internal Revenue*, 11 T.C.M. (CCH) 586 (1952) (comparing compensation levels within the brewing industry in combination with sales, costs, and experience of executives and concluding that compensation was reasonable).

114. Yablon, *supra* note 109, at 1897. For further discussion of the proportionality standard of judicial review in takeover cases, see *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985); *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140 (Del. 1990); *Unitrin, Inc. v. American General Corp.*, 651 A.2d 1361 (Del. 1995). The courts have not generally engaged in the degree of judicial scrutiny that many advocate. *See, e.g.*, Robert B. Thompson & Gordon D. Smith, *Toward A New Theory of the Shareholder Role: Sacred Space in Corporate Takeovers*, 80 TEX. L. REV. (forthcoming 2001). However, they do appear to be more concerned about the quality of board decision making than in the executive pay cases.

115. Compare Vagts, *supra* note 109, at 276 (arguing that these courts do a good job in making these determinations), with *Exacto Spring Corp. v. Comm'r of Internal Revenue*, 196 F.3d 833, 835 (7th Cir. 1999) (rejecting the application of a multifactor test for determining the reasonableness of executive compensation payments in a close corporation in part because of his belief that "[t]he judges of the Tax Court are not equipped by training or experience to determine the salaries of corporate officers; no judges are").

116. *Exacto Spring Corp.*, 196 F.3d at 838. The *Exacto Spring Corp.* decision "may have opened the door for more aggressive compensation planning . . . for key employees of closely held corporations." Scott E. Vincent, *Taxes in Your Practice: How Much Compensation is "Too Much?"—New Focus on the Independent Investor Test*, 56 J. MO. BAR 58, 58 (2000). This test considers the rate of return that investors are earning on their investment in the corporation at issue. A high rate of return indicates that the "independent investor" should be happy with the investment and therefore unlikely to object to the compensation paid to the company's executives. Vincent, *supra*. For a more complete discussion of the independent investor test, as well as an argument that courts are moving to adopt it, see William Barnard, *The Unreasonable Compensation Issue Rises From the Dead and Takes on the Independent Investor*, 93 J. TAX'N 356 (2000).

stronger for close corporations than for public companies. First, close corporations are different from public corporations in some important ways. They experience more potential conflicts of interest when resolving compensation issues than arise in public corporations. There are fewer outside directors, sometimes none, and this is reflected in the composition of the compensation committee. At public corporations, most compensation committees are comprised of outside directors, and fewer conflicts of interest arise. Courts need to look at close corporations more closely to ensure that there is no self-dealing.

Moreover, there are usually fewer procedural safeguards observed at close corporations than at public ones. The more informal setting and smaller financial resources of many close corporations may result in less process being utilized in corporate decision making. The duty of care and its procedural requirements provide less of a check on the boards of close corporations in making their compensation decisions than they do at public corporations.

Third, shareholders are probably better monitors of managerial abuses at close corporations because they are usually more directly involved with the company. Investors in these firms typically wear many hats as directors, officers, and employees. They have strong incentives to ensure that they are not being taken advantage of by their fellow investors.

Finally, close corporations have clear incentives to try to minimize their tax bill by paying out excessive salaries to avoid distributing funds as nondeductible, double-taxed dividends. Because the managers of close corporations are also usually its shareholders, they care little about how they label distributions from the company as long as the money gets into their pocket. This trend is less true at public corporations, where there is a separation of ownership and control, because shareholders only receive distributions from the company if dividends are paid, even if they are subject to double taxation. Thus, while it makes sense in the tax cases to apply a stricter standard of judicial review to close corporations to ensure that the government is not being defrauded, these same concerns do not exist at public corporations.

In the public corporation cases, as the data in this study plainly show, the courts have been more reluctant to intervene in executive compensation. Several justifications for the courts' failure to regulate the substance of executive compensation decisions more closely emerge in the cases and commentaries. First, courts often claim they lack the competence to

determine executive compensation at public corporations.¹¹⁷ This rationale has limited validity. For years, courts have grappled with claims of excessive compensation in cases involving partnerships, insolvent corporations, and close corporations. As several commentators have observed, “In those cases, courts manage to find a fair market value for the services rendered.”¹¹⁸ While the officers at public corporations may have more complicated job functions, and the issues in these organizations may differ from those raised in the close corporate context, the fundamental question in each set of these cases is the same: has the board overpaid for the executive’s services? Judicial incapacity is at best a partial explanation for the courts’ unwillingness to examine critically pay at public corporations.¹¹⁹

A more forceful argument is that courts are comparatively poor monitors of executive compensation.¹²⁰ Boards of directors are better suited than courts for making determinations about the appropriate levels of executive compensation. Directors are more knowledgeable than judges about their companies’ needs and the market for executive talent. They, not the courts, should be responsible for determining the pay levels of officers.

While few would contest the proposition that directors are better monitors in this area than judges, the more difficult issue is what should happen when boards fail to engage in adequate (or any) monitoring. In other words, what do we do when, for no apparent reason, boards hand out a pay package that far outstrips anything other companies are awarding?¹²¹ In the long run, sufficiently egregious abuses may be corrected by market forces.¹²²

117. Yablon, *supra* note 109, at 1896 n.79. Yablon questions the claim that judges are incompetent to determine executive compensation, pointing out that judges routinely determine the value of a human life, damage to a person’s reputation, and other things that involve complex valuation issues. He also notes that courts have regularly determined the reasonableness of executive compensation in closely held corporations for tax purposes, and in cases involving the management fees paid out to mutual fund advisors. *Id.*

118. Barris, *supra* note 109, at 87 (citing Vagts, *supra* note 109, at 255-57).

119. This statement seems particularly true if the courts move toward adopting the “independent investor” test advocated by some appellate courts. See *supra* note 116 for further discussion.

120. Ronald J. Gilson, *Executive Compensation and Corporate Governance: An Academic Perspective*, 792 PLI/CORP. 647, 672-73.

Courts are the least suitable monitor of compensation decisions A court would be charged with evaluating the board’s judgment concerning the trade off between risk sharing and incentives. But because these are “local” decisions that not only lack a determinative conceptual framework, but depend on the peculiarities of particular companies and particular industries, it is difficult to imagine how a court bent on monitoring compensation decisions would proceed.

Id.

121. Judges frequently claim that their role in evaluating executive pay packages should be limited because “[t]hat decision is for the stockholders to make in voting for directors, urging other stockholders to reform or oust the board, or in making individual buy-sell decisions involving . . . securities.” *Brehm*, 746 A.2d at 256.

122. Stewart J. Schwab & Randall S. Thomas, *Realigning Corporate Governance: Shareholder*

Alternatively, dissenting shareholders may choose to offer their own slate of directors and fight a proxy contest to replace the current board of directors. However, unless executive pay has a noticeable negative effect on the corporation's bottom line, these forces are unlikely to be unleashed. And even at the highest paying public companies, the total amounts paid to all of the companies' top executives amount to a minuscule percentage of the companies' gross revenues.

The number of other actors that have the power to check board abuses are few. Shareholders at public corporations have limited abilities to act as monitors of executive compensation, and even when they detect abuses, these investors face serious collective action problems in trying to mount effective opposition to them.¹²³ While they have had some successes in influencing boards to reduce compensation levels, their influence is usually indirect and limited to those instances in which boards are responsive to shareholder initiatives.¹²⁴

Courts have the power to take immediate and direct action in cases when they are convinced that boards are abusing their power, particularly if they fail to follow appropriate procedures. For instance, in *Sanders v. Wang*,¹²⁵ the Delaware Court of Chancery was convinced that the directors of Computer Associates, Inc. were misinterpreting executive compensation plans to unfairly enrich corporate officers, and it ordered the executives to repay the illegally obtained amounts.¹²⁶ This type of monitoring of compliance with contractual terms and processes is often done by judges.

Courts can use this power effectively against a broader set of abuses when they choose to do so. In tax cases, courts have demonstrated an ability to identify outlier compensation arrangements through the use of comparative compensation data. Thus, while there are good reasons to claim that courts should not routinely review executive compensation decisions, they may be the best of a bad set of choices for detecting and correcting serious abuses.¹²⁷

Activism By Labor Unions, 96 MICH. L. REV. 1018, 1083-84 (1998). For example, product and capital markets will punish firms that raise their costs too high.

123. Thomas & Martin, *supra* note 1.

124. *Id.* at 1069.

125. *Sanders v. Wang*, No. 16640, 1999 Del. Ch. LEXIS 203 (Del. Ch. Nov. 10, 1999).

126. *Id.* at *40.

127. One unintended consequence of such monitoring may be herding behavior, whereby all boards seek to insure that they pay their executives within a range set by what other firms are paying. Marcel Kahan, *Economics and Law, Networks and Norms: An Analysis of the Incentive Structure of the Corporation* 36-37 (2000) (working paper, on file with author). This type of reaction appears to inflate executive pay levels even further as boards ratchet up pay levels to stay within the pack. John M. Bizjak et al., *Has the Use of Peer Groups Contributed to Higher Levels of Executive Compensation?* (Nov. 15, 2000) (working paper, on file with authors).

On top of these concerns, creating stronger standards of judicial review may lead to an increase in the number of challenges to executive compensation by the shareholder plaintiffs' bar.¹²⁸ This development is a difficult objection to evaluate. On the one hand, raising the likelihood of success in executive compensation suits should increase the expected value of this type of litigation, and lead rational plaintiffs' lawyers to file more of these cases. More litigation costs will be incurred by the parties, and these costs will be at least in part borne by the corporation. Shareholder value may suffer as a result.

On the other hand, more challenges to executive compensation packages may deter wrongdoing by some boards and eliminate abusive practices that would have otherwise gone uncorrected. Furthermore, directors will have a stronger hand in their negotiations with company insiders, and this may lead to a lower rate of increase of executive pay at all companies and fewer abuses of the process. Shareholders would presumably benefit from these changes.

Furthermore, potential legal liability to shareholders for executive compensation abuses can stimulate directors to become aggressive monitors of all types of managerial misconduct and overreaching. This liability can also be justified on the grounds that directors who knowingly participate or acquiesce in managerial misconduct or overreaching are as blameworthy as the managers who gain directly from the violation.¹²⁹

To summarize, we believe that the strongest case in favor of courts looking closely at executive pay at public corporations is that they are best positioned to police abuses of the executive compensation process. This proposition seems relatively uncontroversial as courts have repeatedly demonstrated their proficiency at ensuring that procedural steps and contractual terms are followed.¹³⁰

A more difficult argument can be made in favor of courts policing the substance of outlier pay packages. This proposal is more likely to provoke claims of judicial incapacity and overreaching. However, courts have determined when pay packages deviate substantially from the norm at close corporations in tax cases. Similar information is easily available at public corporations, where compensation committees routinely use surveys of comparable pay from other companies in setting pay levels for their top executives. These surveys clearly indicate the range of pay received by each individual CEO at many different companies. Courts should require

128. Yablon, *supra* note 109, at 1901-02. Yablon argues that increased costs are unlikely to arise from more stringent standards of judicial review.

129. Cox, *supra* note 74, at 1245.

130. See, e.g., Sanders v. Wang, No. 16640, 1999 Del. Ch. Lexis 203 (Del. Ch. Nov. 10, 1999).

companies to justify pay levels that deviate far from the median levels by extraordinary performance or other special circumstances.

While this change would do little to stop the apparently inexorable rise in the levels of executive pay over the last decade, it would give angry shareholders a more direct method of challenging extraordinary pay packages. However, enacting even modest changes like this will require action either by legislatures or courts. We view the likelihood of such action as remote.

V. CONCLUSION

Litigation challenging executive compensation at corporations has been more successful than is commonly perceived. Our main findings are that plaintiffs have higher success rates at close corporations than at public companies, and that plaintiffs succeed more frequently outside of Delaware than in Delaware, although this latter result is apparently caused by the Delaware courts handling a greater percentage of public company cases than other courts.

Nevertheless, derivative suits do not generally appear to be a strong check on executive pay levels. Moreover, though many shareholders are frustrated by both the courts' reluctance to enter into the business of determining what constitute reasonable levels of compensation, and the state legislatures' lack of interest in creating legislative guidelines, they are unlikely to see any differences in the foreseeable future. If they want to challenge executive pay more forcefully, we believe that they will need to find alternative methods of policing executive compensation practices.

Shareholder voting and selling decisions are unlikely to be fruitful approaches. Shareholders' ability to take direct action is very limited and has been largely ineffective to date. In the voting area, shareholder proposals and coordinated campaigns against company stock option plans have met with only limited success.¹³¹ There is little evidence that investors sell their shares, or mount effective campaigns to remove boards, because of concerns about executive compensation.

One interpretation of these facts is that executive compensation is not an important issue to investors today. Shareholders may accept boards' claims that the current high levels of CEO pay are justified as pay for performance, or necessary to retain talented executives in a tight international labor market. Until recently, long running bull stock market may explain the tremendous

131. Thomas & Martin, *supra* note 2.

value of the stock option grants that boards have awarded to executives.

Shareholders who do not accept those claims may want to seek to strengthen existing approaches to influencing executive compensation directly through coordinated voting and selling campaigns. However, if they want to have a more immediate impact on the size and composition of executive pay packages, investors need to shift their focus onto other factors that directly affect current compensation practices, such as the Financial Accounting Standards Board's (FASB) liberal accounting treatment of stock options¹³² and the SEC's failure to bar executives from engaging in hedging transactions on their stock options.¹³³ These practices have been the subject of much well-deserved criticism, although neither the FASB nor the SEC has been willing to force changes to the status quo. Alternatively, shareholders could urge boards of directors to substitute indexed options in the place of those currently employed at almost all corporations. This action would tie pay and performance for corporate executives more effectively,¹³⁴ and it might also reduce the size of realized gains on option packages.

132. Saul Levmore, *Puzzling Stock Options and Compensation Norms* 7 (Nov. 1, 2000) (working paper, on file with author). *See also* Kahan, *supra* note 127, at 39.

133. David M. Schizer, *Executives and Hedging: The Fragile Legal Foundation of Incentive Compatibility*, 100 COLUM. L. REV. 440, 461 (2000).

134. BRIAN J. HALL, *A Better Way to Pay CEOs?*, in EXECUTIVE COMPENSATION AND SHAREHOLDER VALUE: THEORY AND EVIDENCE (Jennifer Carpenter & David Yermack eds., 1999).

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VI. APPENDIX: TABLES 1-12

Table 1: Demand Futility
Number of times futility raised / Total number of cases (%)

	Delaware Cases	Non-Delaware Cases	Total
<i>Pre-Aronson</i>	3 / 21 (14%)	9 / 50 (18%)	12 / 71 (17%)
<i>Post-Aronson</i>	18 / 24 (75%)	7 / 29 (24%)	25 / 53 (47%)
Total	21 / 45 (47%)	16 / 79 (20%)	37 / 124 (30%)

Table 2: Demand Futility
Number of plaintiff wins using futility / Total number of times futility raised (%)

	Delaware Cases	Non-Delaware Cases	Total
<i>Pre-Aronson</i>	1 / 3 (33%)	4 / 9 (44%)	5 / 12 (42%)
<i>Post-Aronson</i>	7 / 18 (39%)	3 / 7 (43%)	10 / 25 (40%)
Total	8 / 21 (38%)	7 / 16 (44%)	15 / 37 (41%)

Table 3: Duty of Care
Number of plaintiff wins using duty of care / Total number of times duty of care raised (%)

	Delaware Cases	Non-Delaware Cases	Total
<i>Pre-Van Gorkom</i>	0 / 2 (0%)	1 / 2 (50%)	1 / 4 (25%)
<i>Post-Van Gorkom</i>	3 / 9 (33%)	2 / 7 (29%)	5 / 16 (31%)
Total	3 / 11 (27%)	3 / 9 (33%)	6 / 20 (30%)

Table 4: Duty of Care
Number of plaintiff wins using duty of care / Total number of times duty of care raised (%)

	Delaware Cases	Non-Delaware Cases	Total
Public corporation	2 / 8 (25%)	1 / 5 (20%)	3 / 13 (23%)
Close corporation	1 / 3 (33%)	2 / 4 (50%)	3 / 7 (43%)
Total	3 / 11 (27%)	3 / 9 (33%)	6 / 20 (30%)
		Chi-square	p-value
Public v. Close corporation		0.848	0.357
Delaware v. Non-Delaware		0.087	0.769

Table 5: Waste
Number of plaintiff wins using waste / Total number of times waste raised (%)

	Delaware Cases	Non-Delaware Cases	Total
Public corporation	8 / 28 (29%)	8 / 22 (36%)	16 / 50 (32%)
Close corporation	2 / 6 (33%)	21 / 41 (51%)	23 / 47 (49%)
Total	10 / 34 (29%)	29 / 63 (45%)	39 / 97 (40%)
		Chi-square	p-value
Public v. Close corporation		2.891	0.089
Delaware v. Non-Delaware		2.537	0.111

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Table 6: Waste

	Delaware Cases	Non-Delaware Cases	Total
Number of plaintiff wins using waste / Number of times any other claim succeeds	5 / 11 (45%)	20 / 24 (83%)	25 / 35 (71%)
Number of plaintiff wins using waste / Number of times all other claims fail or no other claims made	5 / 34 (15%)	11 / 55 (20%)	16 / 89 (18%)
Total	10 / 45 (22%)	31 / 79 (39%)	41 / 124 (33%)

Table 7: Duty of Loyalty

Number of plaintiff wins using duty of loyalty / Total number of times duty of loyalty raised (%)

	Delaware Cases	Non-Delaware Cases	Total
Public corporation	5 / 20 (25%)	1 / 19 (5%)	6 / 39 (15%)
Close corporation	3 / 7 (43%)	20 / 36 (56%)	23 / 43 (53%)
Total	8 / 27 (30%)	21 / 55 (38%)	29 / 82 (35%)
		Chi-square	p-value
Public v. Close corporation		12.99	0.001
Delaware v. Non-Delaware		0.579	0.447

Table 8
Number of plaintiff wins / Total number of times used (%)

	Futility	Motion to Dismiss	Summary Judgment	Trial	Appeal
Public corporation	7 / 23 (30%)	6 / 29 (21%)	2 / 12 (17%)	6 / 20 (30%)	7 / 21 (33%)
Close corporation	8 / 13 (62%)	5 / 13 (38%)	3 / 6 (50%)	16 / 36 (44%)	14 / 33 (42%)
Total	15 / 36 (42%)	11 / 42 (26%)	5 / 18 (28%)	22 / 56 (39%)	21 / 54 (39%)
Chi-square (p-value)	3.306 (0.069)	1.467 (0.226)	2.215 (0.137)	1.125 (0.289)	0.446 (0.504)

Table 9
Number of plaintiff wins / Total number of times used (%)

	Duty of Care	Waste	Duty of Loyalty	Any of 3 Reasons
Delaware	3 / 11 (27%)	10 / 36 (28%)	8 / 29 (28%)	16 / 44 (36%)
Non-Delaware	3 / 9 (33%)	31 / 67 (46%)	22 / 57 (39%)	35 / 77 (45%)
Total	6 / 20 (30%)	41 / 103 (40%)	30 / 86 (35%)	51 / 121 (42%)
Delaware v. Non-Delaware Cases:				
Chi-square (p-value)	0.087 (0.769)	3.342 (0.068)	1.026 (0.311)	0.949 (0.330)

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Table 10
Number of plaintiff wins / Total number of cases

	Delaware Cases	Non-Delaware Cases	Total
Public corporation	12 / 35 (34%)	8 / 27 (30%)	20 / 62 (32%)
Close corporation	4 / 8 (50%)	25 / 47 (53%)	29 / 55 (53%)
Total	16 / 43 (37%)	33 / 74 (45%)	49 / 117 (42%)

Chi-square (p-value): Delaware v. Non-Delaware corporations: 0.609 (0.435)

Chi-square (p-value): Public corporations: Delaware v. Non-Delaware corporations: 0.151 (0.697)

Chi-square (p-value): Close corporations: Delaware v. Non-Delaware corporations: 0.028 (0.867)

Chi-square (p-value): Public v. Close corporations: 5.017 (0.025)

Chi-square (p-value): Delaware: Public v. Close corporations: 0.688 (0.407)

Chi-square (p-value): Non-Delaware: Public v. Close corporations: 3.853 (0.050)

Table 11: Logistic Regression Results
Dependent Variable: PWINS = 1 if plaintiff wins using duty of care, duty of loyalty, or waste (p-values in parentheses)

Variable	(1)	(2)
Intercept	0.0950 (0.7323)	0.1278 (0.6619)
DELOWRE	0.0979 (0.8266)	
PUBLIC	-0.8926 (0.0372**)	
DELPUBLIC		-0.7784 (0.0911*)
DELCLOSE		-0.1278 (0.8673)
NONDELPUBLIC		-0.9928 (0.0529*)
Chi-square (p-value)	5.092 (0.0784)	5.223 (0.1562)

*,** statistically significant at the .10 and .05 levels, respectively

Variables:

DELOWRE = 1 if Delaware case, 0 otherwise

PUBLIC = 1 if public corporation, 0 if closely-held corporation

DELPUBLIC = 1 if Delaware case and public corporation, 0 otherwise

DELCLOSE = 1 if Delaware case and closely-held corporation, 0 otherwise

NONDELPUBLIC = 1 if non- Delaware case and public corporation, 0 otherwise

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Table 12: Impact of Shareholder Ratification
Number of plaintiff wins using duty of loyalty, care, or waste in shareholder ratification cases (% of cases)

	Delaware Cases	Non-Delaware Cases	Total
Shareholder ratification effective	2 / 13 (15%)	0 / 11 (0%)	2 / 24 (8%)
Shareholder ratification ineffective	3 / 3 (100%)	4 / 4 (100%)	7 / 7 (100%)
Total	5 / 16 (31%)	4 / 15 (27%)	9 / 31 (29%)
		Chi-square	p-value
Shareholder ratification effective v. ineffective		22.102	0.001
Delaware v. Non-Delaware		0.079	0.779

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