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Wasting the Corporate Waste Doctrine: How the Doctrine Can Provide a Viable Solution in Controlling Excessive Executive Compensation

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NOTE

WASTING THE CORPORATE WASTE DOCTRINE: HOW THE DOCTRINE CAN PROVIDE A VIABLE SOLUTION IN CONTROLLING EXCESSIVE EXECUTIVE COMPENSATION

Steven C. Caywood*

In the midst of the global recession of the late 2000s, there was an outcry against corporate executives and what the public deemed to be their excessive compensation. Although this anger is still featured in today's headlines, it is nothing new. In fact, excessive executive compensation complaints arose when the very concept of a corporation was still new. Most of the complaints that the public has leveled have had little effect on boards of directors' decisions. Occasionally, however, the outcry is so great that the public compels a company's leadership to take action. This happened early in 2009 when American International Group ("AIG") stated that it was paying its top executives \$165 million in bonuses. Within days, AIG, a company most Americans had not heard of, was at the center of the excessive compensation debate. Under enormous political and public pressure, fifteen of the top twenty AIG executives agreed to give back their bonuses. This compromise is not typical, however; for every AIG-type controversy, many other payment plans some consider excessive are never publicly discussed. Both private and public proposals are currently under consideration that will limit excessive executive compensation in one way or another. This Note contends that the already existing corporate waste doctrine can serve as a preferable alternative to legislative or executive actions. While the corporate waste doctrine is rarely used by plaintiffs, it could be effectively enforced by using a legislative tool, the say-on-pay provision, as a gatekeeper for the courts. This judicial solution using a legislative act would allow those who are actually affected by the excessive compensation—the shareholders—to pursue effective legal action against the corporation. The corporate waste doctrine would be enforced more narrowly than a statutory scheme, avoiding the possible unintended consequences of a broadly applicable legislative or regulatory action.

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INTRODUCTION

"In a number of instances, executives have received compensation so large as to cause dissatisfaction among factory and office workers, and to lead stockholders to feel that they have been unjustly deprived of funds distributable as dividends."¹ This statement could have easily been made in 2010. Instead, it was written in 1941, when executive compensation was a hot topic with the Great Depression nearing its end in the United States. As this statement suggests, executive compensation has been controversial since the early days of corporate law.²

Although executive compensation reform is not a modern issue, the calls for reform are greater now than ever before. There are many possible reasons for the renewed focus on executive compensation reform. Currently, a

1. George T. Washington, *The Corporation Executive's Living Wage*, 54 HARV. L. REV. 733, 733 (1941).

2. See JOEL SELIGMAN, *THE TRANSFORMATION OF WALL STREET* 25-26 (3d ed. 2003) (noting that excessive executive compensation played a crucial role in arguments for federal securities regulation in the 1930s).

chief executive officer earns roughly 400 times that of an average worker in his or her respective industry—a disparity twenty times greater than in 1965.³ This gap is problematic not merely from a social justice standpoint, but also from an economic standpoint.⁴ Ben Bernanke, Chairman of the Federal Reserve, called the problem of excessive executive compensation a threat to the “dynamism” of capitalism.⁵ Corporations exacerbate this problem when they pay executives large bonuses even when the company loses money.⁶ Shareholders view it as fundamentally unfair when executives are highly compensated while the stock price plummets.⁷ The recession that began in 2008 has stoked frustration even more.⁸

Although previous concerns over this issue failed to generate effective reform, the current iteration of the debate is different. First, as previously pointed out, the level of economic disparity is growing rapidly.⁹ Second, the political climate favors some form of compensation reform. With Democratic majorities in both the Senate and House as well as a Democratic president, there is a strong possibility that some reform will emerge from the

3. Albert R. Hunt, *Letter From Washington: As U.S. rich-poor gap grows, so does public outcry*, N.Y. TIMES, Feb. 18, 2007, available at <http://www.nytimes.com/2007/02/18/world/americas/18iht-letter.4637416.html>.

4. *But see* Robert H. Frank, *Should Congress Put a Cap on Executive Pay*, N.Y. TIMES, Jan. 3, 2009, available at <http://www.nytimes.com/2009/01/04/business/economy/04view.html> (arguing that current executive compensation practices are the result of a properly functioning market). This Note argues that some executive compensation reform will likely occur; it is only a matter of choosing the best method.

5. Ben S. Bernanke, Chairman, Fed. Reserve, Speech Before the Greater Omaha Chamber of Commerce: The Level and Distribution of Economic Well-Being (Feb. 6, 2007), available at <http://www.federalreserve.gov/newsevents/speech/Bernanke20070206a.htm>. Chairman Bernanke explained that “American economic success has resulted from the flexibility and adaptability of our dynamic market economy.” *Id.* He then went on to caution that if drastic income inequality continues, “the public at large might become less willing to accept the dynamism that is so essential to economic progress.” *Id.*

6. For example, Richard Fuld, former CEO of Lehman Brothers, collected roughly \$480 million in compensation in the years leading up to the bank’s collapse in 2008. Jonathan Siban, *Former Lehman Brothers boss attacked over Wall Street excesses*, DAILY TELEGRAPH (London), Oct. 7, 2008, available at <http://www.telegraph.co.uk/finance/financetopics/financialcrisis/3147479/Former-Lehman-Brothers-boss-attacked-over-Wall-Street-excesses.html>. Even corporations that are profitable, however, are still subject to compensation scrutiny. Shareholders recently sued Goldman Sachs even though the company’s share price has risen dramatically and has reported record profits during the past year. *Int’l Bhd of Elec. Workers Local 98 Pension Fund v. Blankfein*, No. 5315 (Del. Ch. filed Mar. 8 2010); *see also* Jonathan Stempel & Steve Eder, *Goldman Sachs Sued by Big Pension Fund Over Pay*, REUTERS, Mar. 8, 2010, available at <http://www.reuters.com/article/idUSTRE62763320100308>.

7. *See Marketplace* (NPR radio broadcast Nov. 2, 2009), available at <http://marketplace.publicradio.org/display/web/2009/11/02/pm-compensation/>.

8. *See* Harwell Wells, “No Man Can Be Worth \$1,000,000 a Year”: *The Fight Over Executive Compensation in 1930s America*, 44 U. RICH. L. REV. 689, 766 (2010) (“Vigorous political efforts to rein in compensation are of a more recent vintage . . .”).

9. *See* Linda Barrett, Note, *Unsharing the Wealth: Recent Economic Volatility Has Greatly Impacted Executive Compensation*, 54 RUTGERS L. REV. 293, 293 (2001) (noting that CEO salaries grew sixfold from 1990 to 2001).

federal government in the near future.¹⁰ Finally, the current global economic crisis is the most severe since World War II.¹¹ It is unlikely a coincidence that the Supreme Court first recognized the corporate waste doctrine in the midst of a similar economic crisis—the Great Depression.¹²

Given these factors, the conditions are ripe for executive compensation reform, and reform appears imminent. The question has become, what form should reform take? This Note examines a variety of potential reforms, including some that have been implemented and others that are under consideration. For instance, a bill currently before the Senate, the Corporate and Financial Institution Compensation Fairness Act, has a say-on-pay provision, which would require shareholders to vote annually on executive compensation structures.¹³ Representative Barney Frank, who introduced the bill, stated that “[u]nder this bill, the question of compensation amounts will now be in the hands of shareholders.”¹⁴ This quote is not entirely accurate, however, because the say-on-pay vote would only be advisory and nonbinding on the board of directors.

Many reform discussions overlook the fact that there is already an existing legal doctrine designed to deal with excessive executive compensation claims: the corporate waste doctrine.¹⁵ A waste claim is a relatively simple one. It is brought by shareholders against a company’s board of directors

10. See Jim Puzzanghera, *Massive Financial Reform Passes House*, L.A. TIMES, Dec. 12, 2009, at A1 (discussing House Speaker Nancy Pelosi’s speech on financial and compensation reform in which she stated that “[w]e are sending a clear message to Wall Street: The party is over”); see also *infra* note 13.

11. See International Monetary Fund, *World Economic Outlook Update*, Jan. 28, 2009, available at <https://www.imf.org/external/pubs/ft/weo/2009/update/01/index.htm> (examining global gross domestic product figures and determining that the most recent recession caused the largest drop in gross domestic product since the end of World War II).

12. *Rogers v. Hill*, 289 U.S. 582 (1933); see also Wells, *supra* note 8, at 766.

13. Corporate and Financial Institution Compensation Fairness Act of 2009, H.R. 3269, 111th Cong. (2009). On July 21, 2010, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010). The Act made say-on-pay federal law. *Id.* at § 951 (codified as amended at 15 U.S.C. 78n-1). The framework of the say-on-pay provision from the earlier bill referenced elsewhere in this Note is largely the same as the framework adopted in the new law. Therefore, the arguments made in this Note are largely intact. The federal say-on-pay provision requires that every three years, shareholders, during their annual meeting, conduct a “separate resolution subject to shareholder vote to approve the compensation of executives.” *Id.* Every six years, the annual shareholder meeting “shall include a separate resolution subject to shareholder vote to determine whether [the say-on-pay required every three years] will occur every 1, 2, or 3 years.” *Id.* Therefore, at the very minimum, a corporation subject to the Security and Exchange Commission’s proxy rules will conduct a say-on-pay vote every three years. *Id.* The shareholder vote will not be binding and not “create or imply any change to the fiduciary duties of such issuer or board of directors.” *Id.* Although it could be argued that a reinvigorated corporate waste doctrine as a result of a disapproving say-on-pay resolution is a change in the board of directors’ fiduciary duties, this Note is instead arguing that the say-on-pay vote should be used as evidence of possible corporate waste, and not an alteration of the standard itself.

14. David Cho & Tomoe Murakami Tse, *House Backs Greater Say On Pay by Shareholders*, WASH. POST, Aug. 1, 2009, at A9.

15. See D. GORDON SMITH & CYNTHIA A. WILLIAMS, *BUSINESS ORGANIZATIONS: CASES, PROBLEMS, AND CASE STUDIES* 532–34 (2d ed. 2008).

alleging that the board wasted company assets.¹⁶ Waste can include any distribution of company assets,¹⁷ but the doctrine, when invoked, is most commonly employed for executive compensation claims.¹⁸ The corporate waste doctrine has been described as an “equitable safety valve,” meaning that it can be used for cases where relief would be otherwise unavailable.¹⁹ Unfortunately, this safety valve is rarely invoked, which allows many seemingly valid excessive compensation claims to go unchecked.²⁰

There are several reasons why the doctrine is not used. For one, the standard adopted for the corporate waste doctrine is impossibly high, which often leads courts to dismiss waste claims at the initial stages of litigation. Because of the doctrine’s infrequent use, there is a dearth of academic debate over its use and effectiveness concerning executive compensation.²¹ The doctrine has potential for meaning again, however, if used with the proposed say-on-pay legislation.

This Note argues that, in conjunction with the proposed say-on-pay resolution, a revitalized corporate waste doctrine would empower shareholders to curb excessive compensation by making shareholders’ say-on-pay votes effectively binding. Part I discusses the viability of a series of potential solutions, including the corporate waste doctrine, that shareholders could use to address excessive executive compensation. Part II proposes a litigation strategy that would invigorate the corporate waste doctrine by using it in conjunction with the say-on-pay resolution, thereby providing shareholders with a viable solution for enforcing excessive executive compensation claims.

I. POTENTIAL EXCESSIVE EXECUTIVE COMPENSATION REFORMS

Executive compensation in large publicly traded firms is often excessive in part “because of the feeble incentives of boards of directors to police compensation.”²² Directors can theoretically be ousted by a vote of shareholders, but this is a rare occurrence.²³ Board members are often influential

16. *Id.*

17. *Id.*

18. *Id.* at 533.

19. *Harbor Fin. Partners v. Huizenga*, 751 A.2d 879, 895 (Del. Ch. 1999).

20. For an example of a case of excessive compensation that has yet to result in a corporate waste claim, see *Siban*, *supra* note 6.

21. The corporate waste doctrine has been the main subject of only one law review article in at least the past five years. See John W. Murrey, III, *Excessive Compensation in Publicly Held Corporations: Is the Doctrine of Waste Still Applicable?*, 108 W. VA. L. REV. 433 (2005) (arguing that the corporate waste doctrine is not clearly defined as applied by Delaware courts and calling for a more coherent explanation of the standard).

22. *Jones v. Harris Assoc.*, 537 F.3d 728, 730 (7th Cir. 2008) (Posner, J., dissenting).

23. See Stephen Deane, *Majority Voting in Director Elections: From the Symbolic to the Democratic*, 1543 PLI/CORP. 331, 352 (2006) (“Furthermore, the ability of shareholders at certain companies to remove directors is far from a universal right. Shareholders can only exercise that right by going through an extraordinary process that is expensive and fraught with restrictions.”).

in company management. Many board chairmen are also CEOs or founders of the corporation.²⁴ It would be extremely difficult to oust these board members, even when they are excessively compensating executives.²⁵ Furthermore, shareholders may realize that ousting a director over one bad action is an unwise decision. It is unreasonable to suggest that shareholders must remove a board member every time there is a disagreement.

As a result of the lack of incentives to the board of directors, many proposals for measures to combat excessive executive compensation have been proposed in recent years. Many of these proposals are at least partially effective, but none of them provides a complete solution. This Part catalogues the most promising resources, both currently available and under consideration, in combating excessive executive compensation. Section I.A discusses the corporate waste doctrine and explains why the doctrine, by itself, fails to provide shareholders with an effective tool for combating excessive executive compensation. Section I.B discusses a bill containing a nonbinding say-on-pay resolution that Congress is currently considering, and argues that this bill alone will also prove inadequate in attempting to prevent excessive executive compensation. Section I.C explains “clawback provisions” and similarly argues that they are ill-equipped to solve the executive compensation problem. Section I.D discusses a strict pay cap on either executive bonuses or total compensation, and likewise posits that such caps will not suffice. Finally, Section I.E examines the effectiveness of increased salary transparency—a proposal already in use—and explains why such transparency has yet to prove effective.

A. *The Corporate Waste Doctrine’s Inability to Provide a Solution on Its Own*

The corporate waste doctrine fails to provide adequate executive compensation reform for two reasons. First, as demonstrated by the Delaware courts, the doctrine imposes an impossibly high standard on shareholder plaintiffs.²⁶ Second, as a result of this high standard, Delaware courts often

24. Corporate best practices now state that the CEO should be separate from the board chairman, and more corporations are following this practice. See Martha Graybow, *More Firms Split CEO and Chairman Roles*, REUTERS, June 16, 2009, available at <http://uk.reuters.com/article/idUKN1634597920080616>.

25. See Deane, *supra* note 23.

26. Because corporate law is generally made at the state level, state courts apply the corporate waste doctrine of their particular state. This Note relies solely on Delaware’s corporate law because its corporate code, the Delaware General Corporation Law, is considered the most sophisticated corporate code in the country. This has made Delaware the state of incorporation for a majority of the most sophisticated U.S. companies and provides it with the country’s most authoritative and cited-to corporate law jurisprudence. See Robert H. Sitkoff, *Corporate Political Speech, Political Extortion, and the Competition for Corporate Charters*, 69 U. CHI. L. REV. 1103, 1142–43 (2002); Marcia Coyle, *Facing the Fallout: Delaware Courts in Crosshairs*, NAT’L L. J., Oct. 13, 2008. Additionally, other states routinely cite Delaware law as support even though Delaware’s law has no binding effect on them. See, e.g., *Mullen v. Acad. Life Ins. Co.*, 705 F.2d 971, 973 n.3 (8th Cir. 1983) (per curiam) (“[C]ourts of other states commonly look to Delaware law . . . for aid in fashioning rules of corporate law.”); Ann M. Scarlett, *Confusion and Unpredictability in Share-*

refuse to allow waste claims to advance beyond the initial stages of litigation.²⁷ Because shareholder plaintiffs are not able to plead facts to meet the high burden imposed by the corporate waste doctrine, no discovery occurs in corporate waste claims, so no determinations are made as to whether boards of directors have committed waste.

*1. The Delaware Courts Don't Apply the Corporate Waste Doctrine
Because the Standard Is Difficult to Enforce in Isolation*

The first criticism, that Delaware courts refuse to apply the corporate waste doctrine because the burden on plaintiffs is impossibly high, is the product of case law that has created an unwieldy doctrine. The corporate waste doctrine is a judicially created doctrine that can be employed by shareholders in an attempt to combat excessive executive compensation. The Supreme Court first recognized the doctrine in 1933.²⁸ In *Rogers v. Hill*, shareholders sued American Tobacco Company directors for paying what the shareholders believed to be excessive bonuses to corporate executives.²⁹ The Court held that corporate waste occurs “[i]f a bonus payment has no relation to the value of services for which it is given,” noting that “it is in reality a gift in part and the majority stockholders have no power to give away corporate property against the protest of the minority.”³⁰ The Court held that a full evidentiary hearing was warranted to determine whether waste occurred.³¹ It remanded to the lower court accordingly.³²

Delaware adopted the corporate waste standard from *Rogers v. Hill* in *Gottlieb v. Heyden Chemical*.³³ In *Gottlieb*, the court approved of the standard espoused in *Rogers* and concluded, “We must evaluate the services to be rendered by the particular employees for the periods reserved, and to that factor we must relate the values of the respective options.”³⁴ After little more development in the doctrine, Delaware examined the corporate waste standard again in the landmark case of *Brehm v. Eisner*.³⁵ *Brehm* was a derivative suit filed by shareholders for wasteful action by Walt Disney

holder Derivative Litigation: The Delaware Courts' Response to Recent Corporate Scandals, 60 FLA. L. REV. 589, 593 (2008).

27. See, e.g., *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000).

28. *Rogers v. Hill*, 289 U.S. 582 (1933).

29. *Id.* at 591.

30. *Id.* at 591–92 (quoting *Rogers*, 50 F.2d at 113–14 (1932)).

31. *Id.* at 592.

32. *Id.*

33. *Gottlieb v. Heyden Chem. Corp.*, 90 A.2d 660 (Del. 1952). The Delaware Supreme Court remanded the case to the trial court for an evidentiary hearing, even though the shareholders approved the compensation plan and there was no claim that the board acted dishonestly or without good faith. *Id.* at 665.

34. *Id.*

35. 746 A.2d 244 (Del. 2000).

Company's board of directors in the hiring and subsequent firing of CEO Michael Ovitz.³⁶

The *Brehm* court discussed the corporate waste standard and decided, as earlier courts had, that there may be a time when compensation is so high as to constitute waste.³⁷ The court then said, however, "If . . . there is *any substantial* consideration received by the corporation, and if there is a *good faith judgment* that in the circumstances the transaction is worthwhile, there should be no finding of waste, even if the fact finder would conclude *ex post* that the transaction was unreasonably risky."³⁸

The waste standard was again examined in *In re The Walt Disney Company Derivative Litigation*. This case examined the events surrounding former Disney CEO Ovitz, just as *Brehm* did.³⁹ The court dismissed the plaintiff shareholders' waste claim because the corporation was contractually obligated to pay Ovitz and there was little to suggest that the contract was wasteful *ex ante*.⁴⁰ The corporate waste standard, as evidenced by the Delaware courts' treatment of waste claims, is extremely difficult for plaintiff shareholders to meet.

Although the corporate waste doctrine seemed all but abandoned after *In re Walt Disney*,⁴¹ a recent Chancery Court decision—*In re Citigroup Inc. Shareholder Derivative Litigation*—may have given it new life.⁴² In reaffirming the corporate waste doctrine, the court stated:

The directors of a Delaware corporation have the authority and broad discretion to make executive compensation decisions. The standard under which the Court evaluates a waste claim is whether there was an exchange

36. *Id.* at 248. Ovitz was hired as the successor to Michael Eisner, chairman and chief executive at the time. *Id.* at 249. Ovitz's contract entitled him to a salary of \$1,000,000 per year for five years, payment of a discretionary bonus, and stock options. *Id.* at 250. If the Board removed Ovitz without cause, he would be entitled to his full contract plus \$10,000,000 with an additional \$7,500,000 for each year remaining on his contract. *Id.* Most importantly, unless fired for cause, Ovitz would be able to exercise his stock options for 3,000,000 shares. *Id.* Just fourteen months after signing this contract, Disney's board removed Ovitz without cause on December 27, 1996. *Id.* at 252. Ovitz then exercised his options and Disney paid him roughly \$140,000,000. *Id.* at 253.

37. *Brehm*, 746 A.2d at 262 n.56 ("[T]here is an outer limit to that discretion, at which point a decision of the directors on executive compensation is so disproportionately large as to be unconscionable and constitute waste.").

38. *Id.* at 263.

39. *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 73–75 (Del. 2006).

40. *Brehm*, 746 A.2d at 263.

41. Indeed, Delaware courts even seemed skeptical that plaintiffs could *ever* prove a waste claim:

[T]he waste theory represents a theoretical exception to the statement very rarely encountered in the world of real transactions. There surely are cases of fraud; of unfair self dealing and, much more rarely negligence. But rarest of all—and indeed like Nessie, possibly non-existent—would be the case of disinterested business people making non fraudulent deals (non-negligently) that meet the legal standard of waste!

Zupnick v. Goizueta, 698 A.2d 384, 387 (Del. Ch. 1997) (internal citation omitted). In Part II, this Note will propose that these cases, while possibly rare, exist.

42. *In re Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d 106 (Del. Ch. 2009).

of corporate assets for consideration so disproportionately small as to lie beyond the range at which any reasonable person might be willing to trade. It is also well settled in our law, however, that the discretion of directors in setting executive compensation is not unlimited. Indeed, the Delaware Supreme Court was clear when it stated that there is an outer limit to the board's discretion to set executive compensation, at which point a decision of the directors on executive compensation is so disproportionately large as to be unconscionable and constitute waste.⁴³

Shareholder plaintiffs claimed that an agreement giving former Citigroup ("Citi") CEO Charles Prince \$68 million, an office, an administrative assistant, and a car and driver for five years constituted waste.⁴⁴ The shareholder plaintiffs pointed to the fact that Prince was largely responsible for the billions of dollars of losses Citi sustained that resulted in the near collapse of the company.⁴⁵ The plaintiff shareholders claimed it was wasteful for the Citi board of directors to pay Prince \$68 million merely for signing "a non-compete agreement, a non-disparagement agreement, a non-solicitation agreement, and a release of claims against the Company."⁴⁶ Denying Prince's motion to dismiss, the court allowed the shareholder plaintiffs to survive early dismissal and continue with discovery.⁴⁷ The litigation is currently ongoing in Delaware courts. *In re Citigroup* may weaken the heavy burden imposed by *Brehm* and *In re Walt Disney* and open the door for a successful shareholder claim of excessive executive compensation.⁴⁸

Thus, while Delaware courts continue to state "that there is an outer limit to the board's discretion to set executive compensation,"⁴⁹ they are reluctant to actually find a case that passes this limit and determine that there is waste. The only thing clear from the Delaware courts' discussion of the substantive standard of the corporate waste doctrine is that plaintiffs face a heavy burden in proving a waste claim.

43. *Id.* at 138 (internal quotation marks and footnotes omitted).

44. *Id.*

45. See Derivative Complaint at ¶ 18, *In re Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d 106 (Del. Ch. 2009) (No. 3338-CC) 2007 WL 5208459.

46. *In re Citigroup*, 964 A.2d at 138.

47. *Id.* at 139.

48. Perhaps because of *In re Citigroup*, corporations expect a rise in shareholder litigation, including a renewed focus on the corporate waste doctrine. See Kevin H. Douglass & D. Scott Holley, *The Path Ahead: Corporate Law Current Trends and Forecasts for 2010*, FIN. FRAUD L., Dec. 28, 2009, at 387, available at <http://www.bassberry.com/files/upload/ThePathAhead2009.pdf> ("Over the next year, we expect more fiduciary duty decisions in the area of corporate oversight, including in the compensation arena (and a possible tightening of the corporate waste doctrine) . . ."). This increase in litigation may actually be harmful to the long-term viability of the corporate waste doctrine: a deluge of corporate waste cases before Delaware courts may lead the overburdened courts to dismiss waste claims in preliminary motions, as they have been prone to do in the past.

49. *In re Citigroup*, 964 A.2d at 138 (internal quotation marks omitted).

2. An Insufficient Number of Corporate Waste Claims Survives a Motion to Dismiss

The eagerness of Delaware courts to dismiss waste claims at an early stage makes the corporate waste doctrine ineffective in controlling excessive executive compensation.⁵⁰ In fact, Delaware's treatment of the corporate waste doctrine may be inconsistent and unworkable as described above because so few waste claims are actually evaluated on the merits. The fact that at least one Delaware court has stated that the doctrine has "many practical problems" might explain in part why the courts have dismissed so many waste claims at this early stage.⁵¹

Delaware courts have had difficulty applying the corporate waste doctrine in part because, when first outlining the doctrine, the Supreme Court⁵² did not provide a threshold for when a corporate waste case could survive a motion for early dismissal.⁵³ In subsequent cases, courts have suggested that they would need to engage in an evidentiary hearing to determine if the board of directors committed waste.⁵⁴ Later Delaware courts have redefined the threshold for dismissal. Following earlier cases,⁵⁵ the Delaware Supreme Court dismissed the *Brehm* waste claim for failure by the plaintiffs to make a demand on the corporation as required under Chancery Rule 23.1.⁵⁶ The purpose of Rule 23.1 is to require plaintiff shareholders to make a demand

50. See Murrey, *supra* note 21, at 457.

51. The Delaware courts have never stated explicitly that this is the reason for its disuse, but they have complained that the doctrine has "many practical problems." *Harbor Fin. Partners v. Hui-zenga*, 751 A.2d 879, 896 (Del. Ch. 1999). It is not surprising, then, that courts would dismiss and rarely invoke a doctrine with "many practical problems."

52. It is important to note that the Supreme Court decision in *Rogers v. Hill* applied New Jersey corporate law and thus was not binding on Delaware state law. See *Rogers v. Hill*, 289 U.S. 582, 584 (1933). Nonetheless, Delaware did adopt the corporate waste standard. *Gottlieb v. Heyden Chem. Corp.*, 90 A.2d 660, 665 (Del. 1952).

53. Murrey, *supra* note 21, at 457.

54. See *Lewis v. Vogelstein*, 699 A.2d 327, 338 (Del. Ch. 1997) (describing that with a valid waste claim, "a full hearing is required regardless of shareholder ratification" (quoting *Michelson v. Duncan*, 407 A.2d 211, 223 (Del. 1979))).

55. *Grobow v. Perot*, 539 A.2d 180 (Del. 1988); *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984).

56. *Brehm v. Eisner*, 746 A.2d 244, 249 (Del. 2000). The portion of Chancery Rule 23.1 the Delaware Supreme Court relied on to dismiss these cases appears as follows:

In a derivative action brought by 1 or more shareholders or members to enforce a right of a corporation or of an unincorporated association, the corporation or association having failed to enforce a right which may properly be asserted by it, the complaint shall allege that the plaintiff was a shareholder or member at the time of the transaction of which the plaintiff complains or that the plaintiff's share of membership thereafter devolved on the plaintiff by operation of law. The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority and the reasons for the plaintiff's failure to obtain the action or for not making the effort.

DEL. CH. CT. R. 23.1 (emphasis added). The demand requirement is met when the plaintiff gives notice to the corporation of its claims and demands the corporation takes action. Plaintiffs are reluctant to make a demand requirement as this empowers the board of directors to form a litigation committee. This committee can recommend that the claim has no merit and Delaware courts will defer to this recommendation. SMITH & WILLIAMS, *supra* note 15, at 671-72.

on the corporation's board of directors before commencing a derivative suit.⁵⁷ If the plaintiffs fail to make a demand of the board of directors, the lawsuit is subject to dismissal unless the plaintiffs' pleadings sufficiently demonstrate that the demand would be futile.⁵⁸ Delaware courts likely invoke Rule 23.1 because the Supreme Court did not define a threshold for dismissal in *Rogers*.

The court in *In re Citigroup*, like earlier courts, concluded that a waste claim that does not contest the independence or personal interest of the board of directors implicates only the second prong of the *Aronson* test.⁵⁹ Under the second prong of the *Aronson* test,

[t]he inquiry . . . is whether a reasonable doubt is created that the Director [d]efendants' "challenged transaction was otherwise the product of a valid exercise of business judgment." In other words, demand will be excused if [p]laintiffs' allegations raise a reasonable doubt that the Board was well-informed, careful and rational in approving [the transaction].⁶⁰

The plaintiffs in *In re Citigroup* were able to raise this "reasonable doubt" and thus survive Rule 23.1 scrutiny.⁶¹

Perhaps because *In re Citigroup* is not the norm and waste claims are routinely dismissed,⁶² Delaware courts provide little detail on the logistics of an evidentiary hearing. An evidentiary hearing would likely require discovery in order for the court to determine if there is waste.⁶³ Discovery, especially in large corporate cases, is an expensive and time-consuming process,⁶⁴ a burden to both the parties as well as the

57. *In re Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d 106, 120 (Del. Ch. 2009).

58. *Id.* But see Murrey, *supra* note 21, at 454 (arguing that waste claims cannot be dismissed on Rule 23.1 grounds because the court always must determine if there is waste). Murrey contends that further litigation is required because the board of directors cannot sanction waste. *See id.* If this is true, then every waste allegation would require an evidentiary hearing and discovery to determine if waste occurred. *Id.*

59. *In re Citigroup*, 964 A.2d at 120 (citing *Aronson v. Lewis*, 473 A.2d 805, 814 (1985)). In Part II, this Note will propose a litigation strategy, which includes pleading the independence and lack of personal interest of the board of directors to fall under the second prong of *Aronson*. Although this would not have been necessary under *Rogers* and *Gottlieb*, modern Delaware corporate law requires it.

60. *In re Walt Disney Co. Derivative Litig.*, 731 A.2d 342, 361 (Del. Ch. 1998) (quoting *Aronson*, 473 A.2d at 814).

61. 964 A.2d at 83–84.

62. *See, e.g.*, *Brehm v. Eisner*, 746 A.2d 244, 263–64 (Del. 2000); *In re The Limited, Inc. S'holders Litig.*, No. CIV.A. 17148-NC, 2002 WL 537692, at *8–9 (Del. Ch. Mar. 27, 2002); *Harbor Fin. Partners v. Huizenga*, 751 A.2d 879, 892–93 (Del. Ch. 1999); *see also* YALE D. TAUBER & DONALD R. LEVY, EXECUTIVE COMPENSATION 730–42 (2002).

63. *Cf. Winkelman v. Gen. Motors Corp.*, 39 F. Supp. 826, 834–35 (S.D.N.Y. 1940) (speaking approvingly of the executive compensation plan but nonetheless denying defendants' motion for summary judgment).

64. When they survive a defendant's motion to dismiss, shareholder suits against corporations tend to settle at a rate higher than that of other civil litigation. *See, e.g.*, Dienna Ching, *Does Negative Equity Negate the Hanging Paragraph?*, 16 AM. BANKR. INST. L. REV. 463, 497 (2008) (describing evidentiary hearings as costly and time-consuming in bankruptcy cases); Jennifer J. Johnson & Edward Brunet, *Critiquing Arbitration of Shareholder Claims*, 36 SEC. REG. L.J. 181,

courts.⁶⁵ Because discovery is so taxing, requiring an evidentiary hearing in every case seems unreasonable and would lead to a tremendous strain on the parties and the courts.⁶⁶ Evidentiary hearings should not always be required as some suggest, but they should be available in certain circumstances—a position for which this Note argues in Part II.⁶⁷ Whatever the function of an evidentiary hearing, the fact remains that courts do not currently have a suitable doctrine to apply in order to use an evidentiary hearing.

B. The Corporate and Financial Institution Compensation Fairness Act of 2009: A Positive Change, but Ineffective on Its Own

The say-on-pay resolution, included as part of the Corporate and Financial Institution Compensation Fairness Act of 2009,⁶⁸ contains some positive attributes, but is ineffective on its own because it is nonbinding on boards of directors. Congress is currently considering a bill that, by giving shareholders a “say on pay,” attempts to reform how banking executives are

201 n.19 (2008) (“Due to the enormous expense involved in proceeding through discovery to trial and the potential for damages that could imperil the company’s future operations, most cases settle if plaintiffs’ complaint survives the motion to dismiss. For example, for securities class actions filed between 1996 and 2007, 81% have been concluded: 41% were dismissed and 59% settled. Only 11 cases went to trial.”).

65. Cf. Robert Mason Hogg, Note, *The Evidentiary Scope of De Novo Review In ERISA Benefits Litigation After Firestone Tire & Rubber Co. v. Bruch*, 78 MINN. L. REV. 1575, 1598 (1994) (citing *Pierre v. Conn. Gen. Life Ins. Co.*, 932 F.2d 1552, 1559 (5th Cir. 1991) to show the Fifth Circuit’s implication that evidentiary hearings are burdensome on the courts).

66. See Murrey, *supra* note 21, at 437 (stating that if an evidentiary hearing was always required, it would “invite excessive litigation”).

67. This Note does not attempt to outline how courts should analyze compensation packages. Many have argued that the important benchmark for best-practices executive compensation is to take long-term company value into account. See, e.g., Lucian A. Bebchuk & Jesse M. Fried, *Pay Without Performance: Overview of the Issues*, 30 J. CORP. L. 647, 669 (2005); Richard C. Ferlauto, *Compensation Best Practices Overview*, 1774 PLI/CORP 47, 51 (“[T]he Committee for Economic Development, a distinguished panel of business and academic leaders, found that [d]ecision making based primarily on short-term considerations damages the ability of public companies, and therefore, of the U.S. economy to sustain superior long-term performance.”) (internal quotation marks omitted). Rather, this Note assumes that if the corporate waste doctrine continues to develop, the courts will develop a robust body of law on best practices for executive compensation. Take, for example, Foreign Sovereign Immunities Act jurisprudence. The Act placed sovereign immunity questions squarely in the jurisdiction of the federal courts. Although the federal courts had little experience with this area of law, they quickly became experts in applying immunity claims. BARRY E. CARTER ET AL., *INTERNATIONAL LAW* (5th ed. 2007); see also Pamela J. Stephens, *Beyond Torture: Enforcing International Human Rights in Federal Courts*, 51 SYRACUSE L. REV. 941, 966 (2001) (“Similarly, as federal courts have over the past twenty years taken on the task of norm-enunciation in the realm of international human rights, confidence has grown in their expertise to address such issues.”). Delaware courts are similarly capable of determining best practices for executive compensation.

68. As of March, 16, 2010, the Corporate and Financial Institution Compensation Fairness Act of 2009 has not passed. It is likely, however, that a say-on-pay provision will pass in some form. On March 15, 2010, Senator Chris Dodd (D-CT) introduced a bill which included a say-on-pay resolution. Sewell Chan, *Dodd to Unveil a Comprehensive Financial Overhaul Bill*, N.Y. TIMES, Mar. 14, 2010, at A18, available at <http://www.nytimes.com/2010/03/14/business/14bank.html>.

compensated.⁶⁹ A say-on-pay resolution would require shareholders to pass a vote on compensation packages at the annual shareholders meeting.⁷⁰ The shareholder vote would be advisory, meaning “[t]he shareholder vote shall not be binding on the corporation or the board of directors and shall not be construed as overruling a decision by such board, nor to create or imply any additional fiduciary duty by such board”⁷¹

Another provision in the bill attempts to prevent “perverse incentives” in compensation packages by appointing a financial regulator.⁷² While the bill does not describe in detail what “perverse incentives” are, the provision is likely aimed at preventing systemic risk—risk that is so large it affects the greater economy.⁷³ The financial regulator provision requires large financial institutions to disclose their compensation plans to a federal regulator.⁷⁴ The regulator would review compensation plans to prevent risks that “(A) could threaten the safety and soundness of covered financial institutions; or (B) could have serious adverse effects on economic conditions or financial stability.”⁷⁵

The proposed bill would provide a good basis for solving the problem of excessive executive compensation, but it would fail to provide a complete solution. Those calling for change to the executive compensation structure generally accept a say-on-pay provision as a positive reform,⁷⁶ because it would give some explicit authority for shareholders to take action. By making the say-on-pay resolution nonbinding, however, the bill adds little to the current law with regard to shareholder rights. Shareholders can already disapprove of a corporation’s compensation package in the same advisory way a say-on-pay resolution would operate. In fact, Shell Oil’s shareholders passed a nonbinding resolution disapproving of executive pay packages in

69. Corporate and Financial Institution Compensation Fairness Act of 2009, H.R. 3269, 111th Cong. (2009). As noted above, “say on pay” is now federal law. *See supra* note 13. Any reference to the previous bill should be supplanted with the Dodd-Frank Bill.

70. H.R. 3269.

71. *Id.*

72. The description of the bill in the first sentence reads, “A Bill [t]o amend the Securities Exchange Act of 1934 to provide shareholders with an advisory vote on executive compensation and to prevent perverse incentives in the compensation practices of financial institutions.” *Id.*

73. These regulators will also have control over executive compensation in these corporations. *Id.* § 4. This is likely to prevent systemic risk—which occurs when a corporation grows so large that its insolvency would drastically affect the entire economy—from materializing. *See generally* RICHARD A. POSNER, A FAILURE OF CAPITALISM: THE CRISIS OF ‘08 AND THE DESCENT INTO DEPRESSION 75–112 (2009) (assessing causes of the financial crisis, including systemic risk).

74. H.R. 3269.

75. *Id.* § 4(a)(3).

76. LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 195–99 (2004).

2009.⁷⁷ Because this resolution was nonbinding, the Shell board of directors took no action, nor was it required to do so.⁷⁸

Nevertheless, the say-on-pay provision would be useful in the sense that it would explicitly mandate routine shareholder votes. Under the current shareholder proposal system, a shareholder can present a resolution only if certain requirements are met.⁷⁹ These resolutions are not frequently proposed, however, because they require an affirmative shareholder act merely to raise a resolution.⁸⁰ The current shareholder resolution system is complicated and results in heavy litigation over the validity of resolutions.⁸¹ Because the say-on-pay votes would be required to occur regularly—at a company's annual meeting⁸²—it would be easier for shareholders to voice their disapproval because the votes would be mandated. Nonetheless, while the say-on-pay provision has many advantages, it still does not provide a complete solution.

The federal regulator provision would be similarly ill-equipped to solve the problem of excessive executive compensation because it is too broad to ensure consistent enforcement. The level of enforcement would depend entirely on the individual federal regulator.⁸³ The regulator's broad discretion could lead to both over- and under-enforcement. A regulator lax on enforcement might rubber stamp all compensation plans. The regulation provision also leads to under-enforcement because it only applies to large financial companies. Other companies that excessively compensate may fly under the regulator's radar. On the other hand, an overly aggressive regulator could bog down corporations because every compensation system could theoretically be subject to painstaking scrutiny.

Additionally, the regulator would not give the shareholders any power to address their concerns about excessive compensation. Instead, the shareholders would be subject to the decisions of the federal regulator. While government regulation is necessary for some corporate governance issues,

77. *Attacking the corporate gravy train*, ECONOMIST, May 30, 2009, at 71 (discussing a British say-on-pay shareholder resolution disapproving of the executive compensation at Royal Dutch Shell). The Shell board of directors notably did not take any action as a result of the nonbinding resolution. *Id.*

78. *Knitting the Purse Strings*, ECONOMIST, Aug. 8, 2009, at 57 ("In May 59% of voting shareholders of Royal Dutch Shell, an oil giant, rejected the executive pay package for 2008, but the company intends to pay it anyway—though it lamely promised to consult shareholders more closely in future.").

79. 17 C.F.R. § 240.14a-8; *see also* SMITH & WILLIAMS, *supra* note 15, at 450–52.

80. These resolutions are increasing, but do not occur as regularly as a say-on-pay proposal would. *See* SMITH & WILLIAMS, *supra* note 15, at 460 (describing these proposals as "an especially vibrant area for corporate governance . . . today").

81. *Id.* at 463.

82. Corporate and Financial Institution Compensation Fairness Act of 2009, H.R. 3269, 111th Cong. § 2 (2009) ("Any proxy or consent or authorization for an annual meeting of the shareholders . . . shall provide for a separate shareholder vote to approve the compensation of executives as disclosed pursuant to the Commission's compensation disclosure rules . . .").

83. H.R. 3269 (providing few guidelines as to when a regulator should exercise his or her authority).

many feel that it is not necessary for executive compensation. As Judge Posner has recognized, the concern is not a lack of government regulation, but instead a lack of any incentive for boards of directors.⁸⁴ Shareholders, not a federal regulator, should provide this incentive, as they are the ones directly affected by excessive executive compensation.

*C. Clawback Provisions Can Be Effective but Are Also Too Narrow
to Provide a Complete Solution*

Although clawback provisions are a well-regarded, market-based approach used to control excessive compensation, they do not broadly curb excessive executive compensation because they are simply a matter of contract between the executive and the corporation. Clawback provisions are one of the most discussed of the recent proposed reforms to executive compensation.⁸⁵ “Clawback provision” is a broad term that describes a mechanism for recovering benefits that a corporation pays an executive.⁸⁶ Clawbacks can take many forms, but are often written into executives’ contracts as express provisions.⁸⁷ Clawbacks are increasing in popularity. Goldman Sachs, for example, recently indicated that it may implement them into executives’ contracts in order to recover from executives whose trades go bad after their bonuses are paid.⁸⁸

Because “clawback” is such a broad term, the utility of clawbacks depends on the form they take. Clawback provisions can be either prospective or retroactive. Prospective clawback provisions are written when the executive compensation contract is negotiated, whereas retroactive clawbacks are invoked after payment to the executive has already been made absent a prospective clawback provision.⁸⁹ An example of a retroactive measure is when the House of Representatives, in response to the AIG bonus payments, passed a bill taxing certain corporations 90 percent on their bonus payments.⁹⁰ Executives who sign a prospective clawback provision, as opposed to a retroactive clawback, are aware that their actions can have negative consequences even after compensation has been received, which incentivizes good action.⁹¹ Conversely, retroactive clawback provisions do not change

84. See *Jones v. Harris Assoc.*, 537 F.3d 728, 730 (7th Cir. 2008) (Posner, J., dissenting).

85. Miriam A. Cherry & Jarrod Wong, *Clawbacks: Prospective Contract Measures in an Era of Excessive Executive Compensation and Ponzi Schemes*, 94 MINN. L. REV. 368 (2009) (arguing for the use of a prospective clawback provision as a method of executive compensation reform).

86. *Id.* at 372–73.

87. *Id.*

88. Andrew Ross Sorkin, *Don't Fail, Or Reward Success*, N.Y. TIMES, Oct. 12, 2009, at B1. Over 300 companies now have some form of clawback provision, up from only fourteen years ago. Gretchen Morgenson, *Pay It Back If You Didn't Earn It*, N.Y. TIMES, June 8, 2008, at B1.

89. Cherry & Wong, *supra* note 85, at 372.

90. H.R. 1586, 111th Cong. § 1 (2009).

91. Cherry & Wong, *supra* note 85, at 392 (“One of the major problems with executive compensation has been a focus only upon short-term performance. Such short-term thinking often leads to opportunistic behavior, at the expense of the long-term health of the company. By in a sense

behavior because executives are unaware that they will be subject to a clawback provision until the actions for which their bonuses are being “clawed back” are complete. Because knowledge of a clawback provision changes incentives, some view prospective clawback provisions as more effective.⁹²

Prospective clawback provisions can be used effectively by corporations, which may lead to satisfied shareholders.⁹³ As a result, derivative lawsuits may be avoided if shareholders feel that the corporation is effectively dealing with excessive executive compensation.⁹⁴ It is unlikely that an executive compensation structure with a prospective clawback provision would be subject to a corporate waste claim.⁹⁵ Even if a corporate waste claim is brought and advances to the evidentiary hearing stage,⁹⁶ the existence of a prospective clawback provision would be evidence against an argument that the board engaged in corporate waste, because the provision affirmatively put in place a mechanism to prevent waste.

Although these provisions may be a good market-initiated safeguard to control executive pay when incorporated into a contract prospectively, they do not broadly curb excessive executive compensation because they are simply a matter of contract between the executive and the corporation. Conceivably, shareholders could begin to demand that clawback provisions become boilerplate language in executive compensation contracts. There would likely be pushback, however, from CEOs who prefer not to have any clawback provision in their contracts. Corporations may be forced to accept contracts without clawback provisions in an effort to attract top CEOs. Short of a broad-based acceptance, clawback provisions would have to be mandated by federal regulation to become an effective tool.

D. Pay Caps Can Be Overly Intrusive on a Corporation

Although pay caps are a simple and effective method of controlling excessive executive compensation, they are overly intrusive and decouple pay from performance. Pay caps function relatively simply: a regulatory body establishes a limit and executives cannot receive compensation that exceeds that limit.⁹⁷

operating as a ‘lead parachute,’ prospective clawback provisions begin to align incentives over a longer time frame.”).

92. *Id.* at 411–12.

93. An example of one such effective use would be to require inclusion of prospective clawback provisions in employment contracts and thereby eliminate the need for retroactive clawback solutions.

94. *See infra* Section II.B.

95. A corporate waste claim likely would not advance without a negative say-on-pay resolution. *See infra* Section II.A. Shareholders would be unlikely to disapprove of a pay structure with a clawback provision because this would provide evidence that the corporation was sensitive to excessive executive compensation. Of course, it is possible that the clawback provision would not be adequate to prevent excessive compensation.

96. *See infra* Section II.A.

97. *See* Deborah Solomon & Mark Maremont, *Bankers Face Strict New Pay Cap: Stimulus Puts Retroactive Curb on Bailout Recipients*, WALL ST. J., Feb. 14, 2009, at A1.

To illustrate, before the 2009 G20 Summit in Pittsburgh, where participating European nations discussed various executive pay reforms,⁹⁸ the French proposed a strict cap on bonuses.⁹⁹ Also in 2009, Congress tightened restrictions on the Troubled Assets Relief Program (“TARP”).¹⁰⁰ Many Americans felt that corporations receiving funds should be restricted in many areas, including executive compensation.¹⁰¹ In response to this criticism, Congress regulated compensation for these companies by restricting compensation “for performance” to one-third of an executive’s securities compensation package.¹⁰²

Although executive salary caps could provide a simple method of enforcing executive compensation reform, such a system would have major flaws. The caps proposed typically only govern one aspect of executive compensation, such as salary. This means that an executive’s total compensation can remain the same by shifting his or her compensation to other forms.¹⁰³ Under such a system, any reform would be illusory. To be fair, the government could easily solve this by deciding to place a cap on total compensation. Such a cap, however, may be overly intrusive and punitive. Many critics of executive compensation reform claim that any reform would cause the best executives in the United States to relocate abroad to avoid regulation,¹⁰⁴ rendering the reform counterproductive.¹⁰⁵

Decoupling compensation from performance is also problematic. First, while it seems like a wise method to lower total pay, imposing strict bonus caps does not accomplish its goal of making executives more accountable to shareholders and increasing long-term corporate value.¹⁰⁶ Nothing in these restrictions would prevent a corporation from increasing an executive’s fixed

98. Stephen Castle, *French Ideas for Curbs on Bonuses Get E.U. Support*, N.Y. TIMES, Sept. 2, 2009, available at <http://www.nytimes.com/2009/09/03/business/global/03euro.html>.

99. Suzy Jagger, *France set to go it alone and cap bank bonuses*, TIMES (London), Sept. 5, 2009, News, at 8. This proposal was not adopted at the G20 summit.

100. Troubled Assets Relief Program, 12 U.S.C.S. § 5221 (West 2009). TARP allowed the government to lend money to struggling banks because of the financial crisis. It was passed in late 2008 but this section of the code was amended in early February 2009. Edmund L. Andrews & Eric Dash, *Stimulus Plan Tightens Reins on Wall St. Pay*, N.Y. TIMES, Feb. 14, 2009, at A1.

101. See Jay Newton-Small, *The AIG Bonuses: Getting Mad and Getting Even*, TIME, Mar. 18, 2009, available at <http://www.time.com/time/politics/article/0,8599,1885977,00.html>.

102. 12 U.S.C.S. § 5221(b)(3)(D)(i)(III).

103. Lucian Bebchuk, *Pay Caps Debate: They Don’t Go Far . . .*, WALL ST. J., Feb. 6, 2009, at A11.

104. Kevin Crowley, *G-20 Pay Plans Risk Losing Top Employees, Bankers Say*, BLOOMBERG, available at <http://www.bloomberg.com/apps/news?pid=20601087&sid=aWjMXU1MbK4Q>.

105. *Id.*

106. Many believe that long-term corporate value means a high stock price. TIM KOLLER ET. AL., VALUATION: MEASURING AND MANAGING THE VALUE OF COMPANIES 391 (4th ed. 2005) (stating that company value, and by extension shareholder value, is driven partially by long-term company outlook). While this is partially true, long-term company value focuses mainly on the future viability of the corporation. See generally Dean Krehmeyer et al., *Breaking the Short-Term Cycle*, CTR. FIN. MKT. INTEGRITY, 2006, available at www.darden.virginia.edu/corporate-ethics/pdf/Short-termism_Report.pdf.

salary, thus severing the tie between compensation and long-term company performance. While an executive's performance may not be adequately measured now,¹⁰⁷ the solution is not to completely sever the relationship between compensation and the corporation's value, but instead to make it closer.¹⁰⁸ Increasing an executive's fixed salary would allow the executive to expose the company to more risk because the executive's salary would not be tied to the corporation's health.¹⁰⁹ The only incentive for an executive receiving a fixed salary would be to keep his job. Thus, an executive would take steps to increase the corporation's value for the time he or she is at the corporation and possibly at the expense of long-term value.¹¹⁰

*E. More Transparency in Executives' Salaries Has Done Little
to Prevent Excessive Executive Compensation*

Although transparency in executives' salaries may be a sensible reform, such disclosure does little to combat excessive executive compensation. This method would require corporations to disclose to the SEC how much they are paying executives.¹¹¹ The rationale behind this requirement is that forcing corporations to disclose their executives' compensation to regulatory bodies would make them more sensitive to how much they are paying their executives.

Reporting executive compensation may play some role in controlling it, but only if corporations fear government action. For example, the Obama Administration in 2009 cut the executive salaries of certain corporations receiving government bailout money by 50 percent.¹¹² Coupling this drastic step with increased salary reporting would be an effective method of controlling executive compensation. Such a system, however, is not optimal because it takes the decision about executive compensation away from where it belongs: with the shareholders who own the corporation.

107. Some agree that deferred compensation such as stock options that do not vest immediately are adequate for prioritizing long-term company value. Rebecca A. Crawford, Note, *Corporate Governance Reform: How to Promote the Long-Term Health and Value of U.S. Corporations*, 5 N.Y.U. J. L. & Bus. 905, 923 (2009) (arguing that "slowly vesting stock options will incentivize directors and executives to focus on the long-term health of their corporations"). However, others have questioned the adequacy of tying compensation predominantly to corporate shares. *Attacking the corporate gravy train*, *supra* note 77 ("[Lucian A. Bebchuk] points out that equity-based bonus plans align bankers' interests only with those of shareholders. This encourages them to make big bets But if those bets go wrong . . . [losses] are borne by unsuspecting bondholders and taxpayers too."). It is possible to tie compensation to long-term performance using executive compensation best practices. See generally Bebchuk & Fried, *supra* note 67.

108. Lucian Bebchuk, Editorial, *Congress Gets Punitive on Executive Pay*, WALL ST. J., Feb. 16, 2009, at A15.

109. David Yermack, Editorial, *Keeping the Pay Police at Bay*, WALL ST. J., Oct. 10, 2009, at W1.

110. *Attacking the corporate gravy train*, *supra* note 77.

111. SMITH & WILLIAMS, *supra* note 15, at 533.

112. Steven Labaton, *U.S. Will Order Pay Cuts at Firms With Bailout Aid*, N.Y. TIMES, Oct. 22, 2009, at A1.

On the other hand, if the government does not act on the disclosures, little would prevent a corporation from paying an exorbitant executive salary,¹¹³ even if the corporation reported it. Corporations might disregard the reporting as a mere formality that would never be questioned. Ironically, this reporting system might even lead to a dramatic *increase* in salary, as executives could cite the highest paid executives as comparisons during salary negotiations.¹¹⁴ In sum, any deterrent effect would be negligible and would not lead to any lowering of excessive executive compensation.

II. A POTENTIAL LEGAL CHALLENGE TO DEVELOPING A WORKABLE CORPORATE WASTE DOCTRINE

This Note has explained how the corporate waste doctrine and the say-on-pay bill, by themselves, are unlikely to make a significant dent in curbing executive compensation. However, a litigation strategy that employs them both, by filing a corporate waste claim after a say-on-pay vote, may give shareholders the power to reduce executive compensation. Specifically, the proposed litigation strategy would succeed even if it only progressed the suit to the discovery phase.¹¹⁵ After a few waste claims successfully pass the motion to dismiss stage, boards of directors will realize that they must listen to their shareholders' say-on-pay votes or else risk incurring significant financial and reputational costs in attempting to make their case on the merits.¹¹⁶ Put another way, this litigation strategy would make the say-on-pay vote effectively binding. These tools that shareholders currently possess could incentivize a corporation's board of directors to curb excessive executive compensation *ex ante*.

Section II.A discusses how a say-on-pay resolution can be used with the corporate waste doctrine to meet Delaware's common law corporate waste standards. Section II.B examines some hallmarks of this litigation strategy that, under model circumstances, would enable shareholders to prevent excessive executive compensation by advancing waste claims beyond a motion to dismiss, to the discovery stage of litigation. Finally, Section II.C addresses the concern that this litigation strategy would lead to a deluge of cases in the Delaware courts if successfully employed.

113. It is unlikely that the corporate waste doctrine provides a deterrent, as evidenced by the substantial increase in executive salaries since reporting began. Hunt, *supra* note 3.

114. SMITH & WILLIAMS, *supra* note 15, at 533.

115. This Note takes no position as to what factors a court should examine when determining a waste claim on its merits. This is a complicated issue that requires a full analysis of executive compensation best practices. See generally BEBCHUK & FRIED, *supra* note 76. Instead, this Note focuses on passing an initial Rule 23.1 dismissal in the hopes of reaching the costly hearing and discovery phase of a case.

116. While a corporation may succeed in proving that there is no waste, an intrusive discovery process is burdensome and can uncover other serious problems. Wells, *supra* note 8, at 730 ("The court reached that conclusion [finding no waste], however, only after commissioning an intrusive and embarrassing examination of National City's compensation plans, which left the directors liable for damages of almost two million dollars [due to other, non-waste oversights].") (discussing *Gallin v. Nat'l City Bank*, 281 N.Y.S. 795, 797-98 (Sup. Ct. 1935)).

A. Using the Say-on-Pay Resolution to Survive Early Dismissal

The model litigation strategy proposed in this Note would include two signature features. First, shareholders should disapprove of their board of directors' executive compensation practices through a say-on-pay resolution. Second, these shareholder plaintiffs should attempt to demonstrate in the pleadings that the consideration was so inadequate that the corporation did not receive any value as a result of the compensation.

Before filing a waste claim, the shareholders should voice their disapproval through a say-on-pay provision. The proposed say-on-pay provision in Congress is nonbinding.¹¹⁷ While a nonbinding provision may be the best standard from a corporate governance standpoint,¹¹⁸ it is not effective in providing the shareholders an adequate avenue for controlling excessive executive compensation.¹¹⁹ A board of directors may choose to ignore the shareholders' advice after a resolution disapproving of the corporation's executive pay packages.¹²⁰ In that case, the shareholders should bring a corporate waste doctrine claim.

Finding a case where a corporation lost value under the executive's leadership will be important in showing that the corporation did not receive any substantial value from an executive. Although not dispositive, it is much easier to argue waste when the corporation's value declines during an executive's tenure. For example, when Charles Prince became CEO of Citi in

117. Corporate and Financial Institution Compensation Fairness Act of 2009, H.R. 3269, 111th Cong. § 2 (2009).

118. Making the shareholder resolution nonbinding preserves the traditional function of the board of directors to manage the corporation. See 1 JAMES D. COX & THOMAS LEE HAZEN, COX & HAZEN ON CORPORATIONS 390-92 (2d ed. 2003).

119. This Note recognizes that a binding say-on-pay resolution may result in a similar outcome as this Note proposes in Part II. However, a binding say-on-pay resolution is not an adequate solution for two reasons. First, it would be extremely difficult for Congress to pass a binding say-on-pay resolution, as evidenced by Congress's failure to do so despite past attempts. In fact, a binding say-on-pay resolution has never been seriously considered in the United States. (Though the Netherlands and Norway recently passed binding say-on-pay legislation.) Stephen Davis, *Does 'Say on Pay' Work? Lessons on Making CEO Compensation Accountable*, 1622 PLI/CORP. 30, 46 (2007). The United States, however, is more inclined to follow the Great Britain model of a nonbinding resolution. Laraine S. Rothenberg and Todd S. McCafferty, *'Say-on-Pay': Linking Executive Pay to Performance*, N.Y.L.J., Sept. 24, 2008, available at <http://www.law.com/jsp/cc/PubArticleCC.jsp?id=1202424735938#27> ("Shareholders and legislators in the United States have generally followed the advisory approach and have not embraced the idea of giving shareholders binding power."). Second, a binding say-on-pay resolution would force the board of directors to take action. This Note proposes a more nuanced approach that allows the board of directors the necessary discretion to manage the corporation while giving shareholders recourse when they feel the board of directors is abusing its power. See *infra* Part II.

120. The Shell board of directors did not take substantial action to adjust executive compensation after shareholders voted to voice their objection to the company's executive pay plan. A say-on-pay resolution is mandated under British law and is nonbinding, much like the proposed U.S. law. Guy Chazan & Joann S. Lublin, *Shell Investors Revolt over Executive Pay Plan*, WALL ST. J., May 20, 2009, at B1 ("Shell Chairman Jorma Ollila said board members 'take the outcome of this vote very seriously and we will reflect carefully upon it.' But Sir Peter Job, head of Shell's remuneration committee, stressed it was 'advisory' and wouldn't invalidate the pay award.").

2003, a share of Citi stock was roughly \$45 per share.¹²¹ When Prince resigned from Citi in 2007, its value had dropped to \$30 per share.¹²² Even worse, after Prince left Citi, the company's stock tumbled to below \$2 per share.¹²³ Additionally, shareholders could look to other metrics of company value such as corporate innovation, reputation, succession planning, and employee development.¹²⁴

One significant hurdle for plaintiffs to overcome in a corporate waste claim is to prove that the board of directors did not act rationally. Plaintiff shareholders should argue that the say-on-pay resolution at least defeats the presumption of rationality and that the court needs to order discovery to determine if waste was committed. The *In re Citigroup* court stated that "the plaintiff must overcome the general presumption of good faith by showing that the board's decision was so egregious or irrational that it could not have been based on a valid assessment of the corporation's best interests."¹²⁵ The court concluded that it could not "determine[] with 'reasonable certainty' that the plaintiff could prevail on no set of facts that may be inferred from the well-pleaded allegations in the complaint."¹²⁶ *In re Citigroup* may mean that the burden set forth in *Brehm* and *In re Walt Disney* is no longer so heavy. In pursuing a litigation strategy, the plaintiffs should cite to *In re Citigroup* for the waste standard and avoid citing earlier Delaware law.¹²⁷

A say-on-pay resolution disapproving of the board should suffice to show that the court cannot reasonably infer that the decision was rational and therefore not wasteful. If over 50 percent of the corporation's shareholders disapprove of a board action, it would raise doubt as to the rationality of that action.¹²⁸ While the plaintiff shareholders may eventually be unable to show that the board acted irrationally, they should at least survive the early dismissal stages of litigation.

121. Google Finance Historical Prices for Citigroup, <http://www.google.com/finance/historical?q=NYSE:C> (last visited May 15, 2010).

122. *Id.*

123. *Id.*

124. See, e.g., Donald P. Delves, *Getting beyond share price: the truer measure of corporate value*, ENTREPRENEUR, June 2008, available at <http://www.entrepreneur.com/tradejournals/article/200909542.htm>; Margery Kraus, Op-Ed, *Reputation is now a tangible measure of corporate value*, PRWEEK, May 26, 2003.

125. *In re Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d 106, 136 (Del. Ch. 2009) (quoting *White v. Panic*, 738 A.2d 543, 554 n.36 (Del. 2001)).

126. *Id.* at 139 (quoting *Malpiede v. Townson*, 780 A.2d 1075, 1082–83 (Del. 2001)).

127. *In re Citigroup* has been cited seven times by the Delaware courts. In fact, a Westlaw search conducted on December 27, 2009 for "964 A.2d 106" in the Delaware's Courts database yielded seven results. In *In re Countrywide Corp. S'holder Litig.*, 2009 WL 846019, at *8 (Del. Ch. Mar. 31, 2009), the court used *In re Citigroup* in discussing the corporate waste doctrine. This is important for plaintiffs because *In re Citigroup* looked more favorably on the corporate waste doctrine compared with *Brehm*.

128. Of course, even a disapproving say-on-pay resolution would not be enough to prove irrationality per se. In fact, it may be likely that there will still be no finding of waste even with a disapproving say-on-pay resolution. The goal of this litigation strategy, however, is merely to pass the initial stages of litigation. See *infra* Section II.B.

Plaintiff shareholders would next have to show that the corporation received no substantial value as a result of compensation paid to the executive.¹²⁹ The standard is difficult to meet, as demonstrated by Delaware case law.¹³⁰ For the purposes of surviving a motion to dismiss though, the standard is not impossible. Plaintiffs in *In re Citigroup* were able to avoid dismissal.¹³¹

In *In re Citigroup*, Charles Prince received \$68 million in compensation after resigning as CEO.¹³² Citi likely received some benefit from Prince's "letter agreement," but the court refused to dismiss the suit.¹³³ Although the court did not discuss its reasoning for allowing the claim to continue, it is possible that the court felt the \$68 million Prince received after leaving the company exceeded any value he might have given the company.¹³⁴

Additionally, the court stated that waste could be found when the consideration received by the corporation was "so disproportionately small as to lie beyond the range at which any reasonable person might be willing to trade."¹³⁵ Plaintiffs can argue that an executive who is in charge of a corporation that decreases in value is not worth a large salary. Having a say-on-pay resolution helps show that perhaps a reasonable person would not be willing to make that deal and discovery is needed to ensure that no waste was committed.

Of course, a proportional standard leads to line-drawing problems. The Supreme Court highlighted this problem in 1933 when it stated that the amount of compensation received by the executives was so large as to warrant investigation, but did not describe what payments qualify for this treatment.¹³⁶ It might be tempting to require all waste claims to undergo further discovery; however, subsequent courts have, quite correctly, rejected this view due to the overwhelming burden this would place on corporations and the courts. A say-on-pay resolution could help to determine if the compensation was disproportionate.

Passing these two hurdles solves the legal complications of bringing a waste claim but does not address most courts' unwillingness to invoke the doctrine. Chancery Judge Strine in *Harbor Finance Partners v. Huizenga*

129. Brehm v. Eisner, 746 A.2d 244, 263 (Del. 2000).

130. *Id.*

131. 964 A.2d at 112.

132. *Id.* at 138.

133. *Id.* at 138–39.

134. Plaintiffs argued this in their brief opposing the motion to dismiss. Plaintiffs' Answering Brief in Opposition to Defendants' Motion to Dismiss or Stay this Action or, in the Alternative, to Dismiss the Consolidated Second Amended Derivative Complaint at ¶ 124, *In re Citigroup Inc. S'holder Litig.*, 964 A.2d 106 (Del. Ch. 2009) (No. 3338-CC), 2009 WL 81303 (stating that Prince received an exorbitant amount of income even despite the "disturbing inadequacies in Citigroup's risk management and control procedures that directly implicated defendant Prince, shedding additional light on his involvement in the Company's historic collapse").

135. *In re Citigroup*, 964 A.2d at 138 (quoting Brehm v. Eisner, 746 A.2d 244, 263 (Del. 2000)).

136. *Rogers v. Hill*, 289 U.S. 582, 591 (1933).

highlighted some of this unwillingness when he levied many criticisms against the corporate waste doctrine.¹³⁷ One criticism was that the corporate waste doctrine should not be enforced to protect the interests of the minority shareholders against the majority.¹³⁸ As support for this argument, Judge Strine argued that because corporate property is not thought of as property of the shareholders, minority shareholders should not have a claim for a gift of *their property*.¹³⁹ While it is open for debate whether a corporation is considered the property of the shareholders, it is likely that Delaware courts will continue to construe the doctrine in this manner. This criticism is inapplicable, however, when a majority of shareholders disapproves of a corporate compensation structure through a say-on-pay provision.

Another of the courts' criticisms is that the corporate waste doctrine is not necessary when the majority of the corporation's shareholders approves a transaction. Chancery Judge Strine stated in *Harbor Finance Partners*:

If fully informed, uncoerced, independent stockholders have approved the transaction, they have, it seems to me, made the decision that the transaction is a fair exchange. As such, it is difficult to see the utility of allowing litigation to proceed in which the plaintiffs are permitted discovery and a possible trial, at great expense to the corporate defendants, in order to prove to the court that the transaction was so devoid of merit that each and every one of the voters comprising the majority must be disregarded as too hopelessly misguided to be considered a person of ordinary sound business judgment.¹⁴⁰

The courts' reasoning for excluding waste claims in the past, however, should permit a waste claim following a say-on-pay resolution. The court in *Harbor Finance Partners* involved a merger that was approved by a majority of shareholders. Other than electing the board of directors, the shareholders do not get a voice in executive compensation. If Congress passes a say-on-pay bill, then shareholders will have a voice, making it difficult to bring a waste claim if the compensation structure is approved by a majority of shareholders. But in using this reasoning, if a say-on-pay measure disapproves of the compensation structure, the "utility of allowing litigation to proceed" is apparent.¹⁴¹ The say-on-pay amendment could give a voice to shareholders concerning executive pay, and the corporate waste doctrine could give force to that voice.

Finally, Delaware courts are concerned about enforcing the corporate waste doctrine because of the feeling that "[c]ourts are ill-fitted to attempt to weigh the adequacy of consideration under the waste standard or, *ex post*, to

137. 751 A.2d 879, 896–900 (Del. Ch. 1999).

138. *Id.* at 899. The court dismissed the explicit language of *Rogers v. Hill*, which stated that "majority stockholders have no power to give away corporate property against the protest of the minority." 289 U.S. at 591–92.

139. *Harbor Fin. Partners*, 751 A.2d at 900.

140. *Id.* at 901 (internal quotation marks and citations omitted).

141. *Id.*

judge appropriate degrees of business risk.”¹⁴² The model litigation strategy described in this section adequately addresses this concern. The courts’ concerns in ruling on waste cases will be alleviated by the presence of a shareholder say-on-pay vote disapproving of the board action. Although a disapproving say-on-pay resolution may not be dispositive of waste, such a resolution would at least allow plaintiff shareholders to advance beyond the initial stages of litigation.

B. *The Rationale of the Model Litigation Strategy*

In pursuing a corporate waste claim in conjunction with a say-on-pay provision, the plaintiff shareholders’ goal should be to pass the initial stages of litigation and require the board of directors to try the case on the merits to determine if there has been waste. If shareholders bring a waste claim *after* voicing disapproval through a say-on-pay resolution, it may force Delaware courts to allow cases to pass Rule 23.1 scrutiny and require an evidentiary hearing and discovery.

As a result of this proposed application of the doctrine, corporations—fearing the financial and reputational costs of further adjudication—will preemptively reform executive compensation to avoid litigation altogether. Breathing life back into the corporate waste doctrine through the say-on-pay provision would prevent corporations from ignoring the wishes of disgruntled shareholders, like those in the Shell Oil situation.¹⁴³ Executive compensation reform should provide accountability to the shareholders, those with the ultimate stake in the business.¹⁴⁴

Shareholders can avoid a Rule 23.1 dismissal by passing a disapproving say-on-pay resolution. A court would be reluctant to defer to the board of directors, as they have in the past, when over 50 percent of the shareholders have disapproved of their action.¹⁴⁵ Using a say-on-pay resolution would also silence the main critics of the corporate waste doctrine who claim that a waste claim is unworkable when there is a fully informed vote of disinterested shareholders who approve an action.¹⁴⁶ A corporate waste doctrine would certainly be viable when shareholders *disapprove* of an action.

142. *Brehm v. Eisner*, 746 A.2d 244, 263 (Del. 2000) (internal quotation marks omitted).

143. *See supra* Section I.B.

144. *Bebchuk & Fried, supra* note 67, at 672 (“The most promising route to improving pay arrangements is thus to make boards more accountable to shareholders and more focused on shareholder interests.”).

145. *E.g. Blasius Indus., v. Atlas Corp.*, 564 A.2d 651, 659 (Del. Ch. 1988) (holding that a board action that stifles a shareholder vote is not entitled to deference and recognizing that corporations have long “dismiss[ed] the stockholder vote as a vestige or ritual of little practical importance”).

146. William T. Allen et al., *Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 BUS. LAW. 1287, 1318 (2001) (“The waste exception, which is a vestige of a long-gone era of corporation law, has no present-day utility. When fully informed, disinterested stockholders have approved a transaction, on what principled basis could a court determine that the transaction is wasteful?”).

C. The Model Litigation Strategy Will Not Lead to Excessive Litigation

Some might argue that there will be an excessive amount of litigation if waste claims routinely are allowed to reach discovery. This makes sense: if the corporate waste doctrine becomes enforceable, more shareholders will invoke it. Boards of directors would prefer to avoid this scenario; they have to make tough decisions and would prefer not to worry about shareholders challenging their every move. This scenario is unlikely to happen, though, for the following reasons. An increase in cases is unlikely to occur because say-on-pay resolutions disapproving of the board of directors would be rare.¹⁴⁷ Shareholders would likely only invoke a negative say-on-pay resolution in the rarest of circumstances because of the practical difficulties of having more than half of the shareholders openly disagree with the board of directors. Waste claims brought without a disapproving say-on-pay resolution should continue to be dismissed at an early stage. The goal of strengthening the corporate waste doctrine is not to increase frivolous lawsuits, but instead to provide shareholders with an avenue to control excessive compensation.

Second, a small increase in litigation should not be a significant concern. Although a larger use of judicial resources means that it will cost more time and money to deal with these issues, the serious call for executive compensation reform should trump these concerns. Taxpayer money would be used for many of the alternative enforcement mechanisms proposed in Part I. The cost of increased resources in a targeted number of cases, however, would likely be smaller than these other, broad-based reforms.

Finally, this type of shareholder power would be limited to excessive compensation claims because the say-on-pay resolution only governs executive compensation. Boards of directors would not need to worry about every decision they make being scrutinized. While it is true that boards of directors must make tough decisions in the best interest of the company, the solution proposed above allows boards to continue to act freely and would only be applied in the most egregious circumstances.

CONCLUSION

Executive compensation reform and regulation is virtually certain to occur in the coming months and years. The current debate deals with what that reform should look like. A say-on-pay provision, somewhat hollow on its own, could be used as a gatekeeper of sorts for corporate waste claims. A revitalized corporate waste doctrine would allow shareholders to have some meaningful power as a safeguard against a board of directors that excessively compensates executives. Using these two tools in tandem would allow

147. Paul Hodgson, *A Brief History of Say on Pay*, IVEY BUS. J., Sept./Oct. 2009, available at http://www.iveybusinessjournal.com/article.asp?intArticle_ID=856 (finding that say-on-pay resolutions will be rare and stating that "[e]ven companies that actually had a vote on pay on the agenda, saw support for excessive pay as usual remain strong") (emphasis omitted).

shareholders to address executive compensation concerns while not overburdening corporations with regulation and litigation.

Returning to the AIG situation discussed at the beginning, executives eventually agreed to pay back their bonuses. For every AIG controversy in the news, though, many other egregious bonus payments fly under the radar. Corporations that do not make the front page of the *Wall Street Journal* will have no public pressure to reduce their executive compensation amounts. A revitalized corporate waste doctrine, in conjunction with a say-on-pay resolution, will provide shareholders in all corporations with a voice against a wasteful board of directors.