9 EXECUTIVE COMPENSATION

9.1 INTRODUCTION

Viewed from a great height, corporation law can be seen to have two main social goals. The first is to facilitate economic enterprise. This goal is advanced by all of the fundamental features of the corporate form discussed in Chapter 3 but, most conspicuously, by a powerful centralized management able to make and implement business decisions efficiently. The second aim of corporate law is to efficiently control the agency costs that accompany this powerful managerial institution. This is especially true for companies that raise equity through public distribution of their shares. We emphasize the ***efficient*** control of agency costs because steps taken to reduce managerial discretion might also deter managers from pursuing new business opportunities that are in the best interests of shareholders and the company. In reducing agency costs, it is possible to have "too much of a good thing."

Shareholder actions to enforce the duty of loyalty are conspicuously directed toward reducing agency costs. But enforcing legal duties in court is a costly and highly imperfect way to encourage senior managers to loyally advance shareholder interests. An *ex ante* approach — that is, an approach that creates incentives for managers to work diligently to increase long-term corporate (and shareholder) wealth — would, if feasible, obviously be better. Such incentive systems are in fact widely used and are at the core of modern executive compensation. Designing and approving executive compensation regimes is one of the principal concerns of modern corporate governance.

But nothing is simple. Designing compensation regimes to align managers' personal interests with corporate wealth production is itself a complex task that is bound to have an imperfect outcome. First, it is difficult to identify what the best measures of corporate performance are for this purpose. Among the many possibilities here are earnings per share, stock price, sales or revenue, or more complex departmental or product-oriented metrics. Second, even if measures of production can be identified, attributing that production to individual members of the management team is complicated. Most production in firms is team production. Third, selecting the time-frame over which production is to be measured is problematic. Investors naturally think in terms of quarterly or annual returns. But firms in different industries and with different challenges may plan in shorter or longer cycles and measurement might optimally differ among them. Fourth, whatever metric is chosen over whatever time-frame, those who will be paid in relation to it will have incentives to "game" the system, i.e., managing to maximize the metrics rather than overall corporate performance. Even worse, as recent corporate scandals illustrate, managers might use guile or deception to maximize their compensation metrics.

These challenges are the central focus of this Chapter. We also address the academic debates about how well public-company boards succeed in shaping these incentives (judged by their results) and the regulatory responses to the problems associated with setting compensation. Finally, we sketch the limited role that judicial review can play in monitoring compensation plans both for senior executives and corporate directors.

9.2 The Challenge of Executive Pay

Incentive compensation is intended in the first instance to induce senior managers to make the extra effort to create corporate value. A second rationale for high-powered incentives is based on a presumed difference between the risk preferences of managers and diversified shareholders. A conventional assumption is that, all else being equal, senior executives would prefer to manage more conservatively than shareholders would like because they cannot diversify the human capital they have invested in their positions. Thus, in addition to rewarding effort, incentive compensation can serve to offset the differences in risk preferences between executives and shareholders. The fundamental challenge of designing stock-based compensation plans (including options, restricted stock and/or phantom stock rights) lies in creating incentives for senior executives to act energetically to advance shareholder interests by assuming risk intelligently—but not to overdo it by taking on excessive risk or to game it by massaging accounting numbers or managing investment to inflate short-term profits at the expense of long-term returns. How well boards manage to "fine tune" compensation incentives is an open question. Executives are people after all, not sports cars; and as between CEOs and the directors on compensation committees, it may not always be clear who is driving whom.

9.2.1 Creating Incentives that Align the Interests of Managers and Investors

In the 1970s and 1980s, CEOs and other top executives were, for the most part, compensated like all other employees of the company, with most of their compensation coming in the form of an annual salary, and then an additional, discretionary bonus paid at the end of the year. The only difference between the CEO and other employees was that the CEO's pay would be set by the board of directors; then the CEO would be responsible, directly or indirectly, for setting the pay for all other employees. During this era, the level of CEO pay was only occasionally controversial; rather, most of the criticism focused on the way in which CEOs were compensated. In 1990, Professors Michael Jensen and Kevin Murphy made the point sharply that CEOs had inadequate financial incentive to maximize value for their shareholders: "[C]orporate America pays its most important leaders like bureaucrats" was their famous claim. If the company did well, the CEO didn't get much more money; and if the company did poorly, she didn't really feel the loss. The correlation between CEO compensation and overall firm performance was low.[1]

One implication of this observation was the conjecture that managerial agency costs were large. If the CEO received a trivially small fraction of any benefits created for the corporation, and suffered only a trivially small fraction of any costs imposed, would he not, for example, be more likely to approve investing in a corporate headquarters palace, rather than a more utilitarian headquarters building? Would he work 24/7 or might he leave the office at 3:00 p.m. some afternoons to play golf? Famous stories, such as RJR Nabisco CEO Ross Johnson flying his dog on the corporate jet at large expense to the corporation, fueled the popular perception during this era that the "private benefits of control" for public-company CEOs were large. Jensen and others argued that the particular compensation system that was commonplace during this era led to increased agency costs and a reduction in overall corporate value.

Business owners had always understood the importance of creating incentives for important employees. Stock options, for example, became an accepted part of executive pay by the early 1950s. Still, Professor Jensen's criticism was that the levels of these incentives were far too small. By the 1990s, the more high-powered performance-based pay began to broadly emerge. Although several metrics could be used to measure performance, such as revenue growth, earnings growth, or subjective assessments, corporate boards gravitated primarily to stock performance as a measure of CEO productivity. Stock-based pay is straightforward: In addition to an annual salary and bonus, the CEO would at the beginning of a pay cycle receive a specified number of shares or options on the shares of the company. If the company did well, the CEO's stock would appreciate in value. Only slightly less intuitive is option-based compensation. A stock option in this context (technically a "call" option) is the right to purchase a share of stock from the company for a fixed price, known as the "strike price" of the option, i.e., the amount that must be paid to the company for a share of its stock. If the strike price is the market price of the stock at the time the grant is made, as is

1. See, e.g., Michael C. Jensen & Kevin J. Murphy, *Performance Pay and Top-Management Incentives*, 98 J. Pol. Econ. 225 (1990) (calculating that CEOs receive, on average, \$3.25 for every \$1,000 increase in shareholder wealth).

normally the case, the option is an "at the money" option. If the strike price is lower than the current market price, the option is granted "in the money." And if the strike price is higher than the current market price, the option is granted "out of the money."

To take a simplified example, a company might grant its CEO the right to buy 100 shares of XYZ Corporation at the current share price of $100 per share. Typically, the option—often called a "warrant"—would have a ten-year exercise period (much longer than exercise periods for options that trade in the financial markets), which means that if the share price of XYZ Corporation went above $100 (say, to $110), the CEO could exercise his right to buy 100 shares of the company at $100, and then sell those shares into the marketplace at $110. In this example, the CEO would make a profit of $10 per share × 100 shares = $1,000. If, instead, the share price of XYZ Corporation stayed at or below $100 for the full ten-year exercise period, the CEO would have no incentive to exercise the options, and the options would expire unexercised.

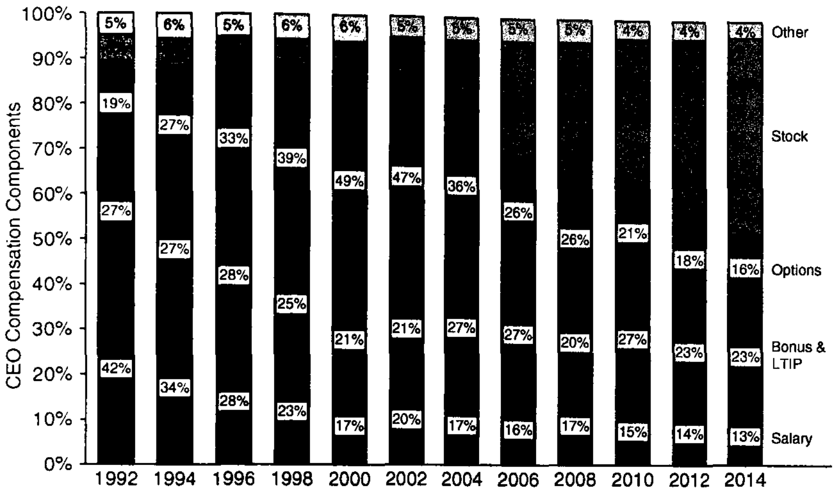
There are variants on this basic model. "Restricted stock" plans make grants of actual shares of stock that vest over a certain period, typically three years. The executive obtains title to the stock only after certain conditions have been met, typically continued employment, but occasionally, hitting certain performance targets as well. "Cliff vesting" stock vests all at once—for example, after continued employment for three years. "Pro rata vesting" stock vests over time—for example, one-third of the stock grant vests each year, for three years. The general idea of restricted stock, of course, is to create incentives for managers to act in the long-term best interests of the corporation. For example, a management decision that might create a temporary increase in the company's stock price might be tempting for a manager who holds stock or stock options in the company, unless the stock or options only vest over some longer period of time.[2]

Stock and stock-option compensation (collectively, "performance-based pay") exploded during the 1990s. The following chart documents the growth of CEO pay at S&P 500 firms during this period and the dramatic shift to performance-based pay, going from a modest level in 1992 to approximately 60 percent of total compensation for the median CEO by 2014. By 2018, it was closer to 70 percent according to ISS Analytics. The chart shows that the greatest part of growth in CEO pay was in the value of share-based incentives, the rise of which reflected in part a general increase in stock market prices across the economy as a whole during those years.[3]

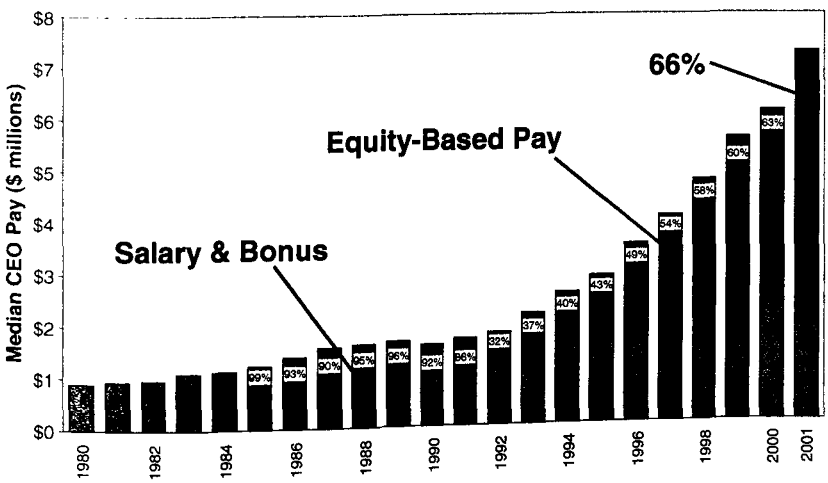
2. There is also "phantom stock," which provides a cash or stock bonus based on the stock price at some future date. If structured properly, phantom stock creates the same economic incentives for the manager as actual stock.

3. Using stock as a metric for senior officer productivity raises some problems because stock price reflects many things unconnected with senior officers performance, such as the Federal Reserve Board's interest rate policy, to name just one obvious factor.

Panel A: CEOs in the S&P 500



Stock markets don't always rise, of course, and when the stock of any company falls enough, its options lose some of their incentive effect. When this occurred in the 1990s, some firms undertook to "reprice" option strike prices by resetting the strike price to something closer to current market. It was thought that the options would recapture the incentive effect that they were designed to create. Of course, this represented a windfall to executives, because their previously "out of the money" options now became substantially more valuable "at the money" options. Critics of this practice pointed out that if executives expected options to be repriced, then the link between pay and performance had been severed.[4] Similar issues may face executive compensation design during the coronavirus pandemic.



4. Yet another pay practice that diluted the incentive effect of stock-option compensation was option "reloading." With reload options, once an executive had exercised her options,

9.2.2 Political and Regulatory Responses to Executive Pay

Clearly, some of the trend toward stock-based pay was influenced by pay experts, directors, and other observers who sought to establish a tighter link between pay and performance. But other factors also were at work in explaining the shift to performance-based pay. Indeed, action by both political and regulatory organs of government has had important effects on both the modern structure and level of executive pay, albeit not always the intended effects.[5]

Perhaps most importantly, in 1993, in response to perceived general unhappiness with high CEO pay, Congress passed §162(m) of the Internal Revenue Code, which stated that compensation above $1 million for the CEO and any of the other four top officers would not be deductible to the corporation for income tax purposes unless it was "performance-based compensation." Stock and stock-option compensation clearly qualified as performance-based compensation, and therefore avoided the $1 million cap. Corporate boards responded to this change in law by increasing the proportion of stock or option-based compensation in the pay packages of senior officers. Although Congress removed the §162(m) exemption for performance-based compensation in 2017, that hardly slowed the move to performance-based pay because by then over 50 percent of the total long-term compensation for Russell 3000 firms was performance-based — underscoring how important it has become.[6]

Boards liked stock-based compensation for accounting reasons as well. Unless they were "in the money" at the time of the grant (which was rare), stock options *were not an expense* to the company under applicable accounting rules.[7] Therefore they did not reduce closely watched performance metrics such as earnings per share (EPS) and price-earnings ratios. In an efficient market, of course, accounting treatment of options should not matter to stock price because investors should "see through" accounting rules to understand that CEOs were taking value out of the company through stock options. In the real world, however, investors seemed to care about accounting measures, and boards, in turn, seemed to view stock-option compensation as a cheap

she would get the same number of new options, struck at the current market price. Of course, reload options created incentives to "ratchet up." Each time the stock price blipped upward, executives might exercise their vested options and then receive new options struck at the new market price. This practice has largely disappeared under institutional investor pressure.

5. The effect, sometimes perverse, of government regulation on the level and structure of executive pay is an understudied aspect of this subject, according to some leading scholars. See, e.g., Kevin Murphy, "Executive Compensation: Where We Are and How We Got There," in Handbook of the Economics of Finance, edited by George Constantinides, Milton Harris & René Stulz (Elsevier Science North Holland 2013).

6. See Matteo Tonello, CEO and Executive Compensation Practices: 2019 Edition, The Conference Board, Inc. (2019).

7. Those rules, Generally Accepted Accounting Principles (GAAP), are promulgated by FASB (Financial Accounting Standards Board), which is the private body charged by the SEC with their development.

tool for compensating the CEO, relative to salary, bonus, or stock — but this changed. In 2004, FASB Statement No. 123 was issued, which required companies to expense the "fair market value" of options at the time of grant.[8] But until then, it is no exaggeration to say that many boards viewed stock options as essentially a "free" way to compensate the CEO.[9]

Ironically, other regulatory measures played a role in rising CEO pay. Also in 1993, the SEC established new rules requiring corporations to make far more detailed public disclosures about the compensation of their top five corporate officers. Three elements were particularly noteworthy. First, companies had to disclose, in a standardized Summary Compensation Table, the annual compensation (salary, bonus, etc.), long-term compensation (restricted stock awards, option awards, etc.), and all other compensation for the top five employees in the company. Second, the 1993 reforms required a narrative description of all employment contracts with top executives, and disclosure of a Compensation Committee report explaining the committee's compensation decisions. Finally, the reforms required a graph showing the company's cumulative shareholder returns for the previous five years, along with a broad-based market index and a peer-group index for the same period.

The net effect of these reforms was increased transparency. Here is the irony: These additional disclosures, rather than dampening CEO compensation, seem to have had the opposite effect. This was due to the particular way in which CEO pay is set. Typically, the compensation committee of the board will hire a compensation consultant, who then identifies a set of comparable companies. Beginning in 1993, the consultant would have excellent visibility of the pay of the top executives at these comparable companies. Using this information, the consultant would prepare a report for the compensation committee. Typically, compensation committees would want to pay their CEO above the 50th percentile among comparable companies (often, for example, at the 75th or 90th percentile),[10] reflecting the fact that their CEO is (of course) above average. But if all boards are aiming to pay their CEO at the 50th percentile or above, then we get a general ratcheting up of CEO pay levels along the lines of what is documented in the chart above. The 1993

8. Although Rule 123 does not require a specific method for valuing the options, the vast majority of U.S. companies have used the Black-Scholes option pricing formula. Critics complain that the Black-Scholes formula overstates the value of options on the income statement because, for example, among other reasons, the Black-Scholes formula assumes that the option-holder is perfectly diversified, which is not the case for managers who are over-invested in their own companies. Even if their financial portfolios were perfectly diversified, managers' "human capital" is invested 100 percent in the company, and cannot be diversified.

9. The New York Stock Exchange and NASDAQ listing standards now require listed companies to seek shareholder approval for *all* stock-option plans except those that are offered as an inducement to new employees or in connection with a merger or acquisition. See www.nyse.com/pdfs/finalruletext303A.pdf; nasd.complinet.com/nasd/display/index.html (Rule 4350-5). Formerly, the NYSE and NASDAQ excluded "broadly based" option plans from required shareholder votes.

10. See, e.g., J.M. Bizjak, M. Lemmon & T. Nguyen, *Are All CEOs Above Average? An Empirical Analysis of Compensation Peer Groups and Pay Design*, 100 J. Fin. Econ. 538 (2011); M. Faulkender & J. Yang, *Is Disclosure an Effective Cleansing Mechanism? The Dynamics of Compensation Peer Benchmarking*, 26 Rev. Fin. Stud. 806 (2013).

disclosure requirement fueled this trend by creating greater visibility on the pay of (arguably) comparable CEOs.

The public perception problem grew worse. In July 2001, *Fortune* magazine, led with a cover story entitled "Inside the Great CEO Pay Heist" and added for good measure: "Why the madness won't stop." In October 2003, the cover story in *The Economist* lamented, "Where's the stick? The problem with lavish executive pay." According to their editors: "CEOs are selected for their cleverness and determination, and they have directed these qualities at boosting their own pay. The more the public spotlight is thrown on one aspect of bosses' remuneration, it seems, the more it rises elsewhere."

Given the way CEO pay is structured today, rising stock markets mean rising pay. CEO pay thus grew dramatically with the market. In 2006, the SEC returned to the issue of executive compensation. As in 1993, the focus of the 2006 reforms was increased disclosure of executive compensation. The new SEC rule required a single number that captured all compensation for each of the top executives, as well as improved disclosures on retirement pay-outs, perquisites, directors' pay, and related-party transactions. As we noted above, designing incentive pay is a delicate problem requiring balance. The danger of stimulating too much risk became apparent in the financial crisis of 2008. Some commentators argued that the massive turn to incentive compensation in the banking and finance industries especially — not just at the most senior executive level but throughout the firms — added fuel to the financial crisis by encouraging executives to make excessively risky investments. If these investments paid off, the stock price or other metric of their performance would go up. They might become wealthy, or at least wealthier, overnight. But they personally had no capital at risk in their trades, so if the investments didn't pay off the corporation would lose, the stock price would fall, and while they would make nothing from that trade or for that year, it would be shareholders and (perhaps) creditors who would experience the full downside consequences. In this analysis, the highly leveraged investments that seemed excessively risky in hindsight were the inevitable consequences of sophisticated managers responding rationally to their compensation systems.

The U.S. Congress, of course, does not need to determine root causes in order to respond to a perceived problem of executive pay. After each of the two major stock market meltdowns of the past two decades, Congress enacted significant reforms in the area of executive compensation. In 2002, Congress passed the Sarbanes-Oxley Act, which among other things responded to several instances from the early 2000s in which top executives reaped large performance-based payments, only later to disclose that the accounting statements that the market had responded to were false or misleading. One might think that if the performance had been a mirage, as it turned out, that they should return the money. Section 304 of the Act provides that if a company must restate its financials as a result of executive misconduct, the CEO and CFO must pay back to the company any bonuses, other incentive-based or equity-based pay, and/or trading profits realized in the 12 months after the incorrect financial information was publicly disclosed. In 2010, §954 of the Dodd-Frank Wall Street Reform and Consumer Protection Act added a more stringent clawback requirement. Publicly listed companies that restate their financial statements due to material noncompliance with GAAP reporting requirements must seek repayment from any current or former executive officer of any incentive-based compensation (including stock options) paid during the three-year period prior to the restatement date.

The clawback provisions in Dodd-Frank cover all publicly traded companies. They go beyond the provisions in the Sarbanes-Oxley Act in three important ways. First, the look-back period is extended from 12 months to three years. Second, clawback coverage is extended from the CEO and CFO to any current or former executive. Third, the Act's provision eliminates the requirement of misconduct to trigger clawbacks. Under the new provision, incentive-based compensation can be recovered in the event of accounting restatements due to a company's material noncompliance with financial reporting requirements, regardless of whether the restatements resulted from executive misconduct. In July 2015, about five years after the passage of Dodd-Frank, the SEC finally issued proposed rules implementing these features of the Act's clawback rules. The proposed rules contemplate requiring the stock exchanges to mandate these standards for all listed companies. Although these rules have not yet been finalized by the SEC, many firms are implementing their own privately designed "clawback" provisions as part of their executive compensation packages. These target not only financial restatements, but also other behavior that firms and their investors wish to discourage (e.g., activities contributing to climate risk, acts of moral turpitude, and other misconduct).[11]

The Dodd-Frank Act also initiated a "Say on Pay" shareholder vote. That is, it requires a shareholder advisory vote at least once every three years to approve or reject the compensation of public companies' named executive officers.[12] In addition, the Act requires a non-binding advisory vote to determine whether Say on Pay votes should occur every one, two, or three years. This requirement mirrors the rule that has governed British companies since 2002. Sweden and Australia have also followed the U.K. advisory-vote approach, while the Netherlands, Switzerland, and Norway have gone further on Say on Pay, providing shareholders with a *binding* annual vote on top executive compensation.[13] By the close of the 2019 proxy season, the pattern on these votes had been established. Shareholders generally approve the compensation practices of the firms in which they are invested.[14] Over

11. For a discussion on connecting compensation and compliance efforts see Karl Hofstetter, Reinier H. Kraakman & Eugene F. Soltes, Compliance, Compensation and Corporate Wrongdoing (May 1, 2018). Conclusions from a Roundtable at Harvard Law School of May 18, 2018, available at SSRN: https://ssrn.com/abstract=3373718.

12. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §951, 124 Stat. 1376, 1899 (2010).

13. Steven Davis, Does "Say on Pay" Work? Lessons on Making CEO Compensation Accountable, 1622 PLI/Corp 33, 46 (2007).

14. See Jill Fisch, Darius Palia & Steven Davidoff Solomon, *Is Say on Pay All About Pay?: The Impact of Firm Performance*, 8 Harv. Bus. L. Rev. 101 (2018) (noting that at most firms shareholder support for executive pay packages is very high, but providing some evidence that the instances of low shareholder support are more likely driven by weak firm performance than the structure of the pay package).

the last nine years, around 97 percent of firms per year obtained majority shareholder approval for executive pay packages and average shareholder support at these firms hovered around 90 percent. The vast majority of firms (91 percent) achieved at least 70 percent shareholder support over the last four years. Larger public companies tended to do a bit better than smaller ones on these votes.[15] These votes are taken with extreme seriousness by corporate management. It has been noted that a failed Say on Pay vote makes it statistically ten times more likely that the next equity pay plan put to the shareholders will also fail. Despite the appearance of general acceptance by shareholders of pay practices, these votes changed corporate governance practice and are useful in focusing compensation committees on the fact that their work will be subject to investor scrutiny.

In addition, §951 of the Dodd-Frank Act regulates "golden parachute" compensation through related disclosure and shareholder approval provisions. Any solicitation of shareholder votes to approve an acquisition, merger, consolidation, or proposed sale of all or substantially all of a public company's assets requires the disclosure of any executive compensation arrangements, including the aggregate amount of potential payments, related to the M&A transaction. Moreover, the Act requires a non-binding shareholder advisory vote in connection with the approval of such compensation arrangements.

Finally, §953 of the Dodd-Frank Act directs the SEC to adopt executive compensation disclosure rules that require public companies to include the relationship between executives' compensation and company performance in annual proxy statements. In addition, companies are required to disclose the median employee annual compensation, the CEO's annual compensation, and the ratio of these figures. Only in April 2015 did the SEC propose rules that aim to give investors greater clarity about the link between what corporate executives are paid each year compared to total shareholder return (TSR)—the annual change in stock price plus reinvested dividends. One report finds that from 2014 to 2018 CEO pay growth at the S&P 500 (at 23 percent) trailed TSR at the S&P 500 (at 50 percent).[16] Further, the SEC rules also require companies to disclose top executives' "actual pay," that is, how much its five highest-paid executives received, after excluding certain contingent components of compensation, such as share grants that have yet to vest.

In August 2015, the SEC also adopted new regulations requiring disclosure of the ratio between CEO pay and that of the median worker.[17] This was a directive of Congress. In an editorial on the day after the new regulation was

15. There have been some notable close calls in 2019, such as at Disney and Netflix, where the executive pay packages received 53 percent and 49.8 percent support, respectively. See Jill Goldsmith, As Rich 2019 Pay Roll In, Media CEO Salaries Will Be Hard to Justify in A *COVID-19* Economy, Deadline, May 1, 2020.

16. See Joseph Bachelder, *CEO Pay Growth and Total Shareholder Return*, Harv. L. School Forum on Corp. Gov., October 12, 2019.

17. Section 953(b) of the Dodd-Frank Act states that "[a] company will be required to calculate the annual total compensation of its CEO in accordance with Item 402(c)(2)(x) of Regulation S-K."

adopted, the *Wall Street Journal* asked whether any investor sensibly needed this disclosure. Recently, Equilar noted that "[t]he CEO Pay Ratio has yet to garner the impact that many key stakeholders initially thought it would have prior to its implementation. . . . The CEO Pay Ratio presents difficulties as a benchmarking figure. It is difficult to incorporate this measurement when setting CEO compensation because the ratio varies on a number of different factors, including company size or the inclusion of international workers."[18] But query, was the "Pay Ratio" in the Act ever really intended to assist compensation committees in designing CEO pay or shareholders in evaluating CEO pay?

QUESTIONS

1. McDonald's Corporation recently filed suit to recover its former CEO Steve Easterbrook's separation (i.e., severance) pay because he allegedly violated terms of his 2019 separation (and termination) agreement. Under the separation agreement, the CEO kept his severance benefits (worth north of $40 million), but the agreement had a clause that allowed the severance plan administrator to block future payments and clawback payments already made if the administrator found that, at any time, the CEO engaged in behavior that would amount to a basis for "cause" termination while employed at McDonald's. "Cause" included lying, fraud, violating "McDonald's Standard of Business Conduct" ("Standards"), or other acts of "moral turpitude." The allegations in the complaint were that the former CEO lied and concealed evidence relating to a consensual physical relationship with an employee (and an associated grant of restricted stock units to that employee) that would have violated McDonald's Standards and the clause in the separation agreement. Indeed, the complaint states the board would never have approved the 2019 separation agreement had it known about these allegations. See Scott Spector, David Bell & Elizabeth Garland, *McDonald's Clawback Suit Against Former CEO: A Cautionary Tale*, Harv. L. School Forum on Corp. Gov., August 26, 2020. How does this type of private ordering compare to the disclosure-based regulation discussed above?

2. In 2019, the SEC amended its disclosure rules so that Item 407(i) of Regulation S-K now requires firms to detail "any practices or policies it has adopted regarding the ability of its directors, officers and employees to purchase securities or other financial instruments, or otherwise engage in transactions, that hedge or offset, or are designed to hedge or offset, any decrease in the market value of equity securities granted as compensation, or held directly or indirectly by the employee or director." This was targeted at concerns that executives could use trading in derivatives markets or securities markets to unwind the incentive effects of performance-based pay packages. These concerns parallel those in Chapter 6 where large institutional investors

18. See Amit Batish & Courtney Yu, *Say on Pay and the Effects of the CEO Pay Ratio: Key Findings from the 2020 Proxy Season*, Harv. L. School Forum on Corp. Gov., June 24, 2020.

can engage in transactions that separate voting rights and economic interest. Does the prospect of unwinding the incentive components of executive pay packages worry you? Is disclosure the best way to police this? Do you think that firms police such behavior themselves via the terms of employment contracts or executive pay packages?

9.3 ARE CEOs PAID TOO MUCH?

Are CEOs paid too much? Reasonable people might have different views, yet the topic evokes far more controversy than whether other people, such as top athletes, movie stars, and hedge fund managers, are paid too much. This is so even though the median CEO of an S&P 500 firm makes less than top earning celebrities and hedge fund managers. Estimates by both ISS Analytics and Pay Governance suggest that the median pay for this group of CEOs in 2018 was around $12.2-$12.4 million.[19] Further, an influential literature argues that among the constellation of factors contributing to a firm's success, no single controllable factor is more important than the skill, energy, and leadership of the firm's CEO.[20] So then why the skeptical attention?

In our view, this attention is not primarily due to the size of executive pay or the intrinsic importance of the CEO's contribution to firm performance. Rather, it is due to the opaque process by which CEO pay is determined—opaque, that is, to outsiders and perhaps even to some insiders, despite the extensive disclosure that SEC rules now require. One might well wonder whether the outsized presence of the CEO on the board might not influence the judgment of the board's compensation committee and its compensation consultant, making negotiations over CEO pay something less than arms-length bargaining.[21] Conversely, one might wonder whether arms-length bargaining between the board and the incumbent CEO is either possible or desirable as long as both parties recognize external norms of compensation that accord with the pay practices of comparable firms.[22] Either way, evaluating the number is nearly impossible without a deep dive into confidential board deliberations and consultant methodologies. Indeed, there is no single number, since compensation arrangements have many parts, ranging from salaries and bonuses to equity compensation to a variety of retirement and contingent severance benefits.[23]

19. See also Alex Edmans, Xavier Gabaix & Dirk Jenter, *Executive Compensation: A Survey of Theory and Evidence*, in The Handbook of the Economics of Corporate Governance (Benjamin E. Hermalin & Michael S. Weisbach, eds.) Vol. 1, 383 (2017) (finding that median CEO pay at the S&P 500 during the 2007-2010 financial crises fell from $9.3 million in 2007 to $7.8 million in 2009 and then rose to nearly $9.3 million in 2010 and $10.1 million by 2014 as the stocks rebounded).

20. See, e.g., id.

21. See the Lucian Bebchuk and Jesse Fried insert, *infra* at page 388.

22. See the Bengt Holmstrom excerpt, *infra* at page 391.

23. Public companies must disclose several numbers for the "total direct compensation" of their top managers, which vary by their components and valuation methodologies.

By contrast, the earnings of celebrities are negotiated at arm's length with sophisticated counterparties, and the quality of their performance is not only available but is often a matter of intense public interest. There are performance statistics for athletes and Oscars for actors, not to speak of weekly box office receipts. Thus, a transparent market may aid in legitimating their compensation. It seems to confirm that they earn what the market will bear. No doubt an elite circle of directors, consultants, and analysts also keep track of rising executive talent in particular industries but their assessments are confidential and their metrics are likely to be fuzzy. If superstar CEOs are "priced" in the eyes of the public, it is typically—as in the case of Steve Jobs—in the twilight of their careers.

These and related considerations have sparked significant scholarly debate on CEO pay. On one hand, Professors Lucian Bebchuk and Jesse Fried, leading representatives of the "agency cost" theory of executive pay, argue in their seminal book *Pay Without Performance: The Unfulfilled Promise of Executive Compensation* (2004), that the process of setting executive pay is not arm's length and the power of managers over the pay-setting process can explain many of the practices that do not seem consistent with financial economic theory—in particular, that CEO pay often does not appear to closely track measures of corporate performance, such as shareholder returns.[24] They provide evidence that CEO pay has grown considerably over the last three decades and is only weakly tied to firm performance, underscoring concerns of board capture by powerful managers. This is consistent with a series of other studies as well.[25]

On the other hand, there is academic research examining some other explanations for CEO pay. In a recent paper surveying the academic literature on executive compensation, Professors Alex Edmans, Xavier Gabaix, and Dirk Jenter highlight that in addition to the agency cost explanation, there is the institutional explanation (i.e., that executive pay is driven by legal, regulatory, and tax factors) and the shareholder value explanation (i.e., that CEO contracts are the outcome of shareholder value maximizing firms that compete with each other in an efficient market for managerial talent).[26] They argue that support can be found for all three approaches in the empirical literature, but that models of shareholder value can explain a great deal of observed behavior.[27]

24. That is, it is less variable than firm performance (but then all worker compensation is steadier than stock market returns). One reason for this is that owners of capital have available to them methods to cheaply diversify the risks embedded in any specific investment, while labor—whether executives or shop-floor employees—cannot do so easily or inexpensively.

25. See, e.g., Kevin J. Murphy, *Executive Compensation*, in Handbook of Labor Economics [1st pg. of excerpt] (Orley Ashenfelter & David Card eds., 1999) (finding that the ratio of CEO pay to the pay of the average worker rose from 25 in 1970 to over 200 by 1996); Franz Christian Ebert, Raymond Torres & Konstantinos Papadakis, Executive Compensation: Trends and Policy Issues (2008), http://www.ilo.org/public/english/bureau/inst/publications/discussion/dp19008.pdf (finding that CEO pay in the United States over 2003-2007 grew in real terms by 45 percent compared to 15 percent for the average executive, and 2.7 percent for the average American worker). See also Lucian Bebchuk & Yaniv Grinstein, *The Growth of Executive Pay*, 21 Oxford Rev. Econ. Pol'y 283 (2005) (finding significant increases in CEO pay not fully explained by improvements in firm performance).

26. See Edmans et al., *supra* note 19.

27. For example, in an influential paper, Professors Xavier Gabaix and Augustin Landier developed a model of CEO pay that assumed only that there is such a thing as managerial talent,

Yet another, more benign, view is offered by Professor Bengt Holmstrom's extract below. Of course, CEOs are usually talented managers and, while powerful, they don't control all of the features of the business environment; when exerting observed effort in a board-approved strategy, poor performance in any one year may be temporary and due to bad luck, not insufficient talent or diligence, and thus not deserving of punishing discipline. Firms are not exactly like markets; they are places in which relational contracting occurs. Boards and (less so) those outside the firm can never know the counter-factual of what performance would have been achieved with the next best CEO.

Although the debate on CEO pay continues vigorously, it is important to note that reaching scientific judgments about it is complicated, in part, because it is difficult to estimate the market price for unique executive talent. Senior officers are not fungible. Moreover, the recent period of high growth in CEO compensation has also been a time of substantially greater CEO turnover, much of it forced.[28] If CEOs get fired more often today than before (something that is not fully consistent with the managerial power/agency costs thesis), then economic theory suggests that we would expect CEO compensation to rise in response to reduced job security. Yet many have significant skepticism about the process of setting executive compensation. Moreover, there are some cases of abusive CEO pay and the general level of CEO pay, compared to that of the average worker, is such that even if it might be efficient,[29] it may create political challenges for corporate boards.

So are CEOs paid too much? Before deciding, read over the three excerpts below.

LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: OVERVIEW OF THE ISSUES

30 J. Corp. L. 647 (2005)

. . . Financial economists studying executive compensation have typically assumed that pay arrangements are produced by arm's-length contracting,

which is rare, that the market for it is competitive, and, most importantly, that this talent produces value as a function of the value of the assets it has the power to direct. Thus, a talented manager can produce more value if he has $10 billion in assets to manage than if he has $1 billion in assets to manage. This simple model predicted that CEO pay should increase one-to-one with the average market capitalization of large firms in the economy. They then find that the roughly six-fold increase in market capitalization of large U.S. companies between 1980 and 2003 can fully explain the roughly six-fold increase in CEO pay during the same period. So for them there is no general problem of excessive CEO pay — just the market for talent working to distribute the rare resource. See Xavier Gabaix & Augustin Landier, *Why Has CEO Pay Increased So Much?*, 123 Q.J. Econ. 49 (2008).

28. See Steven N. Kaplan & Bernadette A. Minton, *How Has CEO Turnover Changed?*, 12 Int'l Rev. Fin. 57 (March 2012).

29. In an era of increasing global competition and technological innovation, shop floor wages in the United States are depressed by low-cost manufacturing options elsewhere and perhaps more efficient manufacturing technologies. These constraints are arguably less pertinent with respect to the market for top managerial talent, especially at large global firms.

contracting between executives attempting to get the best possible deal for themselves, and boards trying to get the best possible deal for shareholders. This assumption has also been the basis for the corporate law rules governing the subject. We aim to show, however, that the pay-setting process in U.S. public companies has strayed far from the arm's-length model.

Our analysis indicates that managerial power has played a key role in shaping executive pay. The pervasive role of managerial power can explain much of the contemporary landscape of executive compensation, including practices and patterns that have long puzzled financial economists. We also show that managerial influence over the design of pay arrangements has produced considerable distortions in these arrangements, resulting in costs to investors and the economy. This influence has led to compensation schemes that weaken managers' incentives to increase firm value and even create incentives to take actions that reduce long-term firm value. . . .

Many take the view that concerns about executive compensation have been exaggerated. Some maintain that flawed compensation arrangements have been limited to a relatively small number of firms, and that most boards have carried out effectively their role of setting executive pay. Others concede that flaws in compensation arrangements have been widespread, but maintain that these flaws have resulted from honest mistakes and misperceptions on the part of boards seeking to serve shareholders. According to this view, now that the problems have been recognized, corporate boards can be expected to fix them on their own. Still others argue that even though regulatory intervention was necessary, recent reforms that strengthen director independence will fully address past problems; once these reforms are implemented, boards can be expected to adopt shareholder-serving pay policies.

Our work seeks to persuade readers that such complacency is unwarranted. To begin with, flawed compensation arrangements have not been limited to a small number of "bad apples;" they have been widespread, persistent, and systemic. Furthermore, the problems have not resulted from temporary mistakes or lapses of judgment that boards can be expected to correct on their own. Rather they have stemmed from structural defects in the underlying governance structure that enable executives to exert considerable influence over their boards. The absence of effective arm's-length dealing under today's system of corporate governance has been the primary source of problematic compensation arrangements. Finally, while recent reforms that seek to increase board independence will likely improve matters, they will not be sufficient to make boards adequately accountable. Much more needs to be done. . . .

Before proceeding, we want to emphasize that our critique of existing pay arrangements and pay-setting processes does not imply that most directors and executives have acted less ethically than others would have in their place. Our problem is not with the moral caliber of directors and executives, but rather with the system of arrangements and incentives within which directors and executives operate. As currently structured, our corporate governance system unavoidably creates incentives and psychological and social forces that distort pay choices. Such incentives and forces can be expected to lead most people serving as directors to go along with arrangements that favor their firms' executives, as long as these arrangements are consistent with prevailing practices and conventions and thus not difficult to justify to themselves and to others. If we were to maintain the basic structure of the system and merely replace current directors and executives with a different set of individuals, the new directors and executives would be exposed to the very same incentives and forces as their predecessors and, by and large, we would not expect them to act any differently. To address the flaws in the pay-setting process, we need to change the governance arrangements that produce these distortions. . . .

ALEX EDMANS, XAVIER GABAIX & DIRK JENTER, EXECUTIVE COMPENSATION: A SURVEY OF THEORY AND EVIDENCE

The Handbook of the Economics of Corporate Governance (Benjamin E. Hermalin & Michael S. Weisbach, eds.) Vol. 1, 383 (2017)

There is considerable debate among both academics and practitioners on what causes the observed trends in pay. There are three broad perspectives. One is the "shareholder value" view, which argues that compensation contracts are chosen to maximize value for shareholders, taking into account the competitive market for executives and the need to provide adequate incentives. . . . [Another is] the "rent extraction" view, which argues that contracts are set by executives themselves to maximize their own rents. . . . A third perspective . . . is that pay is shaped by institutional forces, such as regulation, tax, and accounting policies.

[W]e make the following broader points:

- Observed compensation arrangements result from a combination of potentially conflicting forces—shareholders' desire to maximize firm value, executives' desire to maximize their rents, and the influence of legislation, taxation, accounting policies, and social pressures. No one perspective can explain all of the evidence. . . .
- Recent theoretical contributions make clear that shareholder value models can be consistent with a wide range of observed compensation patterns and practices, including the large increase in executive pay since the 1970s [as noted below — EDS.].
- Theories of executive pay must take into account the specific features of executives' jobs; models of the general principal-agent problem are not automatically applicable to executives. For example, the skills of executives may be particularly scarce, and CEOs have a much larger impact on firm value than rank-and-file employees, which can fundamentally change the nature of the optimal contract.
- Attempts to improve CEO pay should focus on the incentives created, and especially on the sensitivity of CEO wealth to long-term performance. The level of pay receives the most criticism, but usually amounts to only

a small fraction of firm value. Badly structured incentives, on the other hand, can easily cause value losses that are orders of magnitudes larger.

[S]hareholder value . . . identifies three mechanisms that might explain the rise in CEO pay since the 1970s. First, the difference between the CEO's contribution to firm value and that of the next best manager may have increased, perhaps because the importance of CEO ability has grown. Second, the CEO's expected earnings in the next best job may have increased, perhaps because CEO skills have become more portable. Third, the CEO's disutility from the optimal contract may have increased, perhaps because risk and effort levels have increased.

BENGT HOLMSTROM, PAY WITHOUT PERFORMANCE AND THE MANAGERIAL POWER HYPOTHESIS: A COMMENT

30 J. Corp. L. 503 (2005)

. . . Let me start with one anecdotal piece of evidence that explains why I think [Bebchuk & Fried's] basic premise that boards should deal with the executives at arm's-length is rather misguided. I have been on the board of my wife's family business for sixteen years. It is a closely held, global company headquartered in Finland with about 3000 employees and one billion dollars in revenue. There is an outside CEO, but the family controls the board and owns over ninety-five percent of the equity. The chairman of the board, my brother-in-law, is the former CEO. I think it is safe to say that the company does not face the sorts of agency problems that Bebchuk and Fried consider crucial. Yet many of the compensation patterns that the book attributes to a toxic combination of CEO power and wimpy boards can also be found in this reasonably successful family firm.

To determine a CEO's compensation, we consider several factors. We call in a compensation consultant. We look at compensation levels in companies of comparable size. We look at the CEO's mix of bonus and salary. We ask the compensation consultants what they think is appropriate. We ask the CEO what he expects to be paid and how. We are concerned about incentive effects, but in the end we closely follow common practice. The CEO has options as well as a bonus plan, with the bonus tied to strategic goals. Currently, we pay him in the top quartile, because we think it is important that he feels appreciated. When all is said and done, it looks pretty much boilerplate.

Why are we this unimaginative? After thirty years of studying compensation and incentives, do I not have better ideas?

My answer comes in three parts. First, and most importantly, we want to avoid arm's-length bargaining. Compensation is a sensitive matter. We benchmark to remove potentially contentious negotiations from the agenda. If we err, we would rather err a bit on the generous side. Second, we have tried to be more creative about structure, including the use of relative performance evaluation. But the executives did not like the use of relative performance evaluation much and in the end we felt that it would cost us more than it was worth to force acceptance. Third, years of experience with incentive design has made me cautious about experimenting too much. The law of unintended consequences never fails to surprise (we have certainly made our share of mistakes), and when it does it can cause a lot of frustration. Following norms and relying on outside expertise is not so bad after all — let the others be guinea pigs.

One data point does not prove a broader thesis, of course, but I would be rather surprised if my experience differed much from the experience of most family boards. I feel fairly confident in saying that CEO pay is very unlikely to be determined by arm's-length bargaining in most companies, whether they are publicly traded or closely held. But that does not mean that a board should go along with whatever the CEO demands. Benchmarking and staying within norms provide a good defense against overly aggressive demands. The biggest pay excesses have occurred in firms that have used unusual structures (the use of mega-grants is illustrative) and that have not benchmarked properly (Oracle, Siebel Systems and Apple are three examples). For this reason, it is surprising that the Conference Board's recent expert panel on executive compensation recommends that boards should avoid benchmarking and use their own judgment in its place. I know of no economic price which individuals can reliably determine by looking at intrinsic value without regard to the price of comparable products or services. Why should executive markets be any different? . . .

QUESTIONS

1. Much of the literature on the rise in CEO pay focuses on the terms of the compensation package and how it is negotiated rather than the process for how CEOs are hired (or fired). Shouldn't that matter? A recent study exploring how CEOs are hired finds "that firms hire from a surprisingly small pool of candidates. More than 80% of new CEOs are insiders. . . . More than 90% of new CEOs are executives firms are already familiar with. . . . Firms raid CEOs of other firms in only 3% of cases. . . . The evidence . . . suggests that firm-specific human capital and personal connections determine CEO hiring." Peter Cziraki & Dirk Jenter, *The Market for CEOs* (July 6, 2020). Available at SSRN: https://ssrn.com/abstract=3644496. How does this influence your thinking on what theory or theories explain the rise in CEO pay?

2. Consider the following description of how CEO pay is set. "[E]very board I have ever sat on or researched benchmarked itself at the 50th, 75th, or 90th percentile, therefore targeting CEO pay at similarly exalted levels. Benchmarking below the 50th percentile says, 'We are a lousy company and don't even aspire to be better.' So in this sense all CEOs are above average: To be benchmarked at or above the 50th percentile, they need not do anything other than report to a board that considers its own company exceptional." Steven Clifford, *How Companies Actually Decide What to Pay CEOs*, The Atlantic, June 14, 2017. Assuming that this is an accurate description, what does it tell us about the factors that might drive CEO pay?

9.4 Judicial Review of Compensation

9.4.1 The Law of Executive Officer Compensation

Some might think that judicial review would act as an important constraint on executive compensation, perhaps as a backstop when other mechanisms fail — it is not — unless actual corruption in the process of awarding compensation can be shown. Delaware courts, if asked to review executive compensation, will defer to the business judgment of the board of directors by deploying the "waste" standard of judicial review. Although specific definitions vary, perhaps the best articulation in this context was set forth in *Gottlieb v. Hayden Chemical Corporation* in 1952. A wasteful transaction is one "that no person of ordinarily sound business judgment would be expected to entertain the view that the consideration furnished. . . . is a fair exchange."[30]

The Delaware judicial approach reflects both the enormous difficulty in assessing executive pay from outside the boardroom, and the courts' traditional respect for the decisions of non-conflicted corporate directors. The compensation practices at large financial institutions during the financial crisis tested this approach to reviewing compensation decisions. Newspapers were filled with accounts of top professionals getting paid astronomical sums, while taxpayers funded bailouts of their banks. Famed investment banking house Goldman Sachs was a special object of this critical review and plaintiff-shareholders did challenge Goldman's pay practices in Delaware Chancery Court. The opinion, excerpted below, fairly illustrates the unwillingness of the Delaware courts to bend to what may be thought to be the popular sentiment on executive pay.

IN RE THE GOLDMAN SACHS GROUP, INC. SHAREHOLDER LITIGATION

2011 WL 4826104 (Del. Ch. Oct. 12, 2011)

GLASSCOCK, V.C.

C. COMPENSATION

[Opinion on Defendant's Motion to Dismiss the Complaint — EDS.] Goldman employed a "pay for performance" philosophy linking the total compensation of its employees to the company's performance. Goldman has used a Compensation Committee since at least 2006 to oversee the development and implementation of its compensation scheme. The Compensation Committee was responsible for reviewing and approving the Goldman executives' annual compensation. To fulfill their charge, the Compensation

30. 90 A.2d 660 (Del. 1952).

Committee consulted with senior management about management's projections of net revenues and the proper ratio of compensation and benefits expenses to net revenues (the "compensation ratio"). [Net revenue is gross revenue minus the cost of goods sold and thus does not include the cost of compensation or taxes. Net *earnings* are net revenue less operating expenses (which includes compensation) and less taxes. Goldman Sachs continues to rely on a similar compensation structure.* — Eds.]

The Plaintiffs allege that from 2007 through 2009, the Director Defendants approved a management-proposed compensation structure that caused management's interests to diverge from those of the stockholders. According to the Plaintiffs, in each year since 2006 the Compensation Committee approved the management-determined compensation ratio, which governed "the total amount of funds available to compensate all employees including senior executives," without any analysis. Although the total compensation paid by Goldman varied significantly each year, total compensation as a percentage of net revenue remained relatively constant. Because management was awarded a relatively constant percentage of total revenue, management could maximize their compensation by increasing Goldman's total net revenue and total stockholder equity. The Plaintiffs contend that this compensation structure led management to pursue a highly risky business strategy that emphasized short term profits in order to increase their yearly bonuses.

D. Business Risk

The Plaintiffs allege that management achieved Goldman's growth "through extreme leverage and significant uncontrolled exposure to risky loans and credit risks." The trading and principal investment segment is the largest contributor to Goldman's total revenues; it is also the segment to which Goldman commits the largest amount of capital. The Plaintiffs argue that this was a risky use of Goldman's assets, pointing out that Goldman's Value at Risk (VAR) increased between 2007 and 2009, and that in 2007 Goldman had a leverage ratio of 25 to 1, exceeding that of its peers.

The Plaintiffs charge that this business strategy was not in the best interest of the stockholders, in part, because the stockholders did not benefit to the same degree that management did. Stockholders received roughly 2% of the revenue generated in the form of dividends — but if the investment went south, it was the stockholders' equity at risk, not that of the traders.

The Plaintiffs point to Goldman's performance in 2008 as evidence of these alleged diverging interests. In that year, "the Trading and Principal Investment segment produced $9.06 billion in net revenue, but as a result of discretionary bonuses paid to employees lost more than $2.7 billion." This contributed to Goldman's 2008 net income falling by $9.3 billion. The Plaintiffs contend that, but for a cash infusion from Warren Buffett, federal

* See The Goldman Sachs Group Inc., Proxy Statement 2019. Available at: https://www.sec.gov/Archives/edgar/data/886982/000119312519082951/d635602ddef14a.htm. See also *Goldman Sachs Cuts Bankers' Bonus Pot by 20% as Profits Fall*. The Guardian, April 15, 2019.

government intervention and Goldman's conversion into a bank holding company, Goldman would have gone into bankruptcy.

The Plaintiffs acknowledge that during this time Goldman had an Audit Committee in charge of overseeing risk. The Audit Committee's purpose was to assist the board in overseeing "the Company's management of market, credit, liquidity, and other financial and operational risks." The Audit Committee was also required to review, along with management, the financial information that was provided to analysts and ratings agencies and to discuss "management's assessment of the Company's market, credit, liquidity and other financial and operational risks, and the guidelines, policies and processes for managing such risks." . . .

III. ANALYSIS

A. Approval of the Compensation Scheme

The Plaintiffs challenge the Goldman board's approval of the company's compensation scheme on three grounds. They allege (1) that the majority of the board was interested or lacked independence when it approved the compensation scheme, (2) the board did not otherwise validly exercise its business judgment, and (3) the board's approval of the compensation scheme constituted waste.

B. Otherwise the Product of a Valid Exercise of Business Judgment

. . . Plaintiffs contend that the entire compensation structure put in place by the Director Defendants was done in bad faith and that the Director Defendants were not properly informed when making compensation awards. I find that the Plaintiffs have not provided particularized factual allegations that raise a reasonable doubt whether the process by which Goldman's compensation scheme allocated profits between the employees and shareholders was implemented in good faith and on an informed basis.

1. Good Faith

. . . The Plaintiffs allege that "[n]o person acting in good faith on behalf of Goldman consistently could approve the payment of between 44% and 48% of net revenues to Goldman's employees year in and year out" and that accordingly the Director Defendants abdicated their duties by engaging in these "practices that overcompensate management." The complaint is entirely silent with respect to any individual salary or bonus; the Plaintiffs' allegation is that the scheme so misaligns incentives that it cannot have been the product of a good faith board decision.

The Plaintiffs' problems with the compensation plan structure can be summarized as follows: Goldman's compensation plan is a positive feedback loop where employees reap the benefits but the stockholders bear the losses. Goldman's plan incentivizes employees to leverage Goldman's assets and engage in risky behavior in order to maximize yearly net revenue and their yearly bonuses. At the end of the year, the remaining revenue that is not paid as compensation, with the exception of small dividend payments to stockholders, is funneled back into the company. This increases the quantity of assets Goldman employees have available to leverage and invest. Goldman employees then start the process over with a greater asset base, increase net revenue again, receive even larger paychecks the next year, and the cycle continues. At the same time, stockholders are only receiving a small percentage of net revenue as dividends; therefore, the majority of the stockholders' assets are simply being cycled back into Goldman for the Goldman employees to use. The stockholders' and Goldman employees' interests diverge most notably, argue the Plaintiffs, when there is a drop in revenue. If net revenues fall, the stockholders lose their equity, but the Goldman employees do not share this loss.[138]

. . . The Plaintiffs acknowledge that the compensation plan authorized by Goldman's board, which links compensation to revenue produced, was intended to align employee interests with those of the stockholders and incentivize the production of wealth. To an extent, it does so: extra effort by employees to raise corporate revenue, if successful, is rewarded. The Plaintiffs' allegations mainly propose that the compensation scheme implemented by the board does not perfectly align these interests; and that, in fact, it may encourage employee behavior incongruent with the stockholders' interest. This may be correct, but it is irrelevant. The fact that the Plaintiffs may desire a different compensation scheme does not indicate that equitable relief is warranted. Such changes may be accomplished through directorial elections, but not, absent a showing unmet here, through this Court.

Allocating compensation as a percentage of net revenues does not make it virtually inevitable that management will work against the interests of the stockholders. Here, management was only taking a percentage of the net revenues. The remainder of the net revenues was funneled back into the company in order to create future revenues; therefore, management and stockholder interests were aligned. Management would increase its compensation by increasing revenues, and stockholders would own a part of a company which has more assets available to create future wealth.**

138. In actuality, of course, a drop in revenue does have a direct negative impact on employees, because their income is tied to revenue.

** The 2007 to 2009 Annual Reports for Goldman Sachs reveal the following ($ in millions):

	2009	*2008*	*2007*
Net revenue	$45,173	$22,222	$45,987
Compensation ("Comp")	$16,193	$10,934	$20,190
Comp as % of net revenue	35.8%	49.2%	43.9%
Net earnings	$12,192	$2,041	$11,407

The Plaintiffs' focus on percentages ignores the reality that over the past 10 years, in absolute terms, Goldman's net revenue and dividends have substantially increased. Management's compensation is based on net revenues. Management's ability to generate that revenue is a function of the total asset base, which means management has an interest in maintaining that base (owned, of course, by the Plaintiffs and fellow shareholders) in order to create future revenues upon which its future earnings rely.

. . . The Plaintiffs do not allege that the board failed to employ a metric to set compensation levels; rather, they merely argue that a different metric, such as comparing Goldman's compensation to that of hedge fund managers rather than to compensation at other investment banks, would have yielded a better result. But this observance does not make the board's decision self-evidently wrong, and it does not raise a reasonable doubt that the board approved Goldman's compensation structure in good faith.

2. *Adequately Informed*

. . . The Plaintiffs allege that the Director Defendants fell short of this reasonableness standard in several ways. . . . They point out that the Director Defendants never "analyzed or assessed the extent to which management performance, as opposed to the ever-growing shareholder equity and assets available for investment, has contributed to the generation of net revenues." The Plaintiffs also argue that because the amount of stockholder equity and assets available for investment was responsible for the total revenue generated, the Director Defendants should have used other metrics, such as compensation levels at shareholder funds and hedge funds, to decide compensation levels at Goldman. The Plaintiffs allege that Goldman's performance, on a risk adjusted basis, lagged behind hedge fund competitors, yet the percentage of net revenue awarded did not substantially vary, and that the Director Defendants never adequately adjusted compensation in anticipation of resolving future claims.

Nonetheless, the Plaintiffs acknowledge that Goldman has a compensation committee that reviews and approves the annual compensation of Goldman's executives. The Plaintiffs also acknowledge that Goldman has adopted a "pay for performance" philosophy, that Goldman represents as a way to align employee and shareholder interests. The Plaintiffs further acknowledge that Goldman's compensation committee receives information from Goldman's management concerning Goldman's net revenues and the ratio of compensation and benefits expenses to net revenues. . . .

	2009	*2008*	*2007*
Ratio Comp/Net earnings	1.33	5.36	1.77
Common stock dividends	$588	$642	$639
Preferred stock dividends	$ 1,076	$204	$192
Total dividends	$ 1,664	$846	$831

Rather than suggesting that the Director Defendants acted on an uninformed basis, the Plaintiffs' pleadings indicate that the board adequately informed itself before making a decision on compensation. The Director Defendants considered other investment bank comparables, varied the total percent and the total dollar amount awarded as compensation, and changed the total amount of compensation in response to changing public opinion. None of the Plaintiffs' allegations suggests gross negligence on the part of the Director Defendants, and the conduct described in the Plaintiffs' allegations certainly does not rise to the level of bad faith such that the Director Defendants would lose the protection of an 8 Del. C. §102(b)(7) exculpatory provision.

At most, the Plaintiffs' allegations suggest that there were other metrics not considered by the board that might have produced better results. The business judgment rule, however, only requires the board to reasonably inform itself; it does not require perfection or the consideration of every conceivable alternative. . . .

3. *Waste*

The Plaintiffs also contend that Goldman's compensation levels were unconscionable and constituted waste. . . . Specifically, to excuse demand on a waste claim, the Plaintiffs must plead particularized allegations that "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."[152]

"[W]aste entails an exchange of corporate assets for consideration so disproportionately small as to lie beyond the range at which any reasonable person might be willing to trade."[153] Accordingly, 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."[154] The reason being, "[c]ourts are ill-fitted to attempt to weigh the 'adequacy' of consideration under the waste standard or, ex post, to judge appropriate degrees of business risk."[155] Because of this, "[i]t is the essence of business judgment for a board to determine if a particular individual warrant[s] large amounts of money."[156] . . .

The Plaintiffs consciously do not identify a particular individual or person who received excessive compensation, but instead focus on the average compensation received by each of Goldman's 31,000 employees. The Plaintiffs allege that "Goldman consistently allocated and distributed anywhere from two to six times the amounts that its peers distributed to each employee," and

152. *Citigroup*, 964 A.2d at 136 (quoting *White v. Panic*, 783 A.2d 543, 554 n.36 (Del. 2001)).
153. *Lewis v. Vogelstein*, 699 A.2d 327, 336 (Del. Ch. 1997).
154. Id.
155. Id.
156. *Brehm*, 746 A.2d at 263 (internal quotations omitted).

the Plaintiffs provide comparisons of Goldman's average pay per employee to firms such as Morgan Stanley, Bear Stearns, Merrill Lynch, Citigroup, and Bank of America. The Plaintiffs note that these firms are investment banks, but do not provide any indication of why these firms are comparable to Goldman or their respective primary areas of business. The Plaintiffs do not compare trading segment to trading segment or any other similar metric. A broad assertion that Goldman's board devoted more resources to compensation than did other firms, standing alone, is not a particularized factual allegation creating a reasonable doubt that Goldman's compensation levels were the product of a valid business judgment.

The Plaintiffs urge that, in light of Goldman's increasing reliance on proprietary trading, Goldman's employees' compensation should be compared against a hedge fund or other shareholder fund. The Plaintiffs allege that Goldman's compensation scheme is equal to 2% of net assets and 45% of the net income produced, but a typical hedge fund is only awarded 2% of net assets and 20% of the net income produced. The Plaintiffs paradoxically assert that "no hedge fund manager may command compensation for managing assets at the annual rate of 2% of net assets and 45% of net revenues," but then immediately acknowledge that in fact there are hedge funds that have such compensation schemes. It is apparent to me from the allegations of the complaint that while the majority of hedge funds may use a "2 and 20" compensation scheme, this is not the exclusive method used to set such compensation. Even if I were to conclude that a hedge fund or shareholder fund would be an appropriate yardstick with which to measure Goldman's compensation package and "even though the amounts paid to defendants exceeded the industry average," I fail to see a "shocking disparity" between the percentages that would render them "legally excessive."

In the end, while the Goldman employees may not have been doing, in the words of the complaint and Defendant Blankfein, "God's Work," the complaint fails to present facts that demonstrate that the work done by Goldman's 31,000 employees was of such limited value to the corporation that no reasonable person in the directors' position would have approved their levels of compensation. Absent such facts, these decisions are the province of the board of directors rather than the courts. . . .

[The court also considered and rejected the plaintiffs' claim that the board had breached its duty to monitor as required under *Caremark*.]

9.5 Judicial Review of Director Compensation

The role of the corporate board in the practical operation of corporate governance of large public companies has been transformed over the past 25 years. Today's board is in general more engaged as an active agent in monitoring and directing the major affairs of the firm than was the case in earlier decades. Concomitantly, service on the board of a public company today takes greater commitment in time and effort. One result of these greater demands is a rise in compensation that is paid to directors of large public companies.