

# **EXECUTIVE PAY: POTENTIAL LITIGATION PITFALLS**

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**EXECUTIVE COMPENSATION LAWSUITS**

- **Avoiding the Pitfalls** -

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**I. INTRODUCTION**

One of the lightning rod issues facing America's corporations today is the compensation of corporate executives. Each week there is a new revelation of an even higher executive compensation package, and each new revelation stimulates the arguments for reform. In recent years, Plaintiffs' lawyers have filed numerous shareholder derivative actions to challenge the compensation arrangements for executives. With the advent of the federal pay czar, the growing disparity between the compensation of executives and compensation of average American workers,<sup>2</sup> and increasing public scrutiny and dislike for the big paydays for corporate executives, the environment for explaining and defending the huge payouts to corporate executives has become increasingly hostile.

In anticipation of this hostility, both inside and outside counsel need to play a role in the negotiations, review and approval of executive compensation. The process must be fair and transparent to improve its chances for acceptance by courts should the compensation package be challenged in a lawsuit. The purpose of this discussion is to identify and describe the pitfalls that should be avoided in the review and approval of an executive compensation package. If these pitfalls are avoided, the opportunity for plaintiff shareholders to attack executive compensation should be sharply reduced.

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<sup>2</sup> In 1991, the average large company CEO earned 140 times the average company employee; by 2003 it was 500 times. Bebchuk & Fried: The Unfulfilled Promise of Executive Compensation, at 1 (2004)

## **II. DISCLOSURE AND GOVERNANCE STANDARDS**

Unless your company is one of those that is beholding to the authority of the federal pay czar, your primary concerns are to meet the SEC disclosure requirements for executive compensation and to observe the necessary formalities to assure that executive pay decisions are not evaluated *de novo* by a court.

### **A. Current SEC Disclosure Rules and Proposed Rule Making.**

The SEC has made major changes regarding the disclosure requirements of executive compensation in proxy statements. SEC Release 33-8732A/34-54302A. The new regulations require disclosure in a standard tabular form and also require an improved narrative disclosure. The SEC rules also require the Board's Compensation Committee to review and recommend the proposed disclosure. The SEC also now provides on its website an on-line tool that permits investors to compare what the 500 largest American companies are paying their top executives.

In 2009, SEC chairman Mary Shapiro, announced that the SEC is considering new and additional disclosures regarding executive compensation packages. Clearly, the SEC is greatly concerned with assuring public companies make maximum disclosure each year regarding executive compensation, and how to do that remains a subject of ongoing rule making.

### **B. The Disney Cases and the Importance of Process.**

Executive pay packages are routinely negotiated, reviewed and approved by the Board of Directors who frequently act through the Board's Compensation Committee. The goal is to provide for a process that evidences either the Board's or the Compensation Committee's business judgment in approving the compensation package. If the process is not flawed, courts routinely choose not to second guess the directors' determination of what is fair compensation for the corporation's executives. The result is that numerous cases are dismissed at the pleading stage because the court has deferred to the business judgment of the directors.

While each state may have its own formulation of a business judgment rule for corporate governance purposes, the law of Delaware often applies or is cited by courts in formulating a statement of the business judgment rule. Not surprisingly, Delaware courts have been among the most prominent in the development

of the business judgment rule as it has been applied to the review of executive compensation. In that regard, the *Disney* cases, *Brehm v. Eisner*, 731 A.2d 342 (1997), *Brehm v. Eisner*, 746 A.2d 244 (2000), *In Re the Walt Disney Company Derivative Litigation*, 825 A.2d 275 (2003), *In Re The Walt Disney Derivative Litigation*, 907 A.2d 693 (2005) and *In Re Walt Disney Company Derivative Litigation*, 906 A.2d 27 (2006), provide an exhaustive analysis of the role of process and the business judgment rule in a lawsuit challenging an executive pay package for Michael Ovitz. In these cases, the Delaware Supreme Court described the legal test for deferring to the directors' business judgment:

Thus, directors' decisions will be respected by courts unless the directors are interested or lack independence relative to the decision, do not act in good faith, act in a manner that cannot be attributed to a rational business purpose or reach their decision by a grossly negligent process that includes the failure to consider all material facts reasonably available. *Brehm v. Eisner*, 746 A.2d 244, 264 at FN 66 (2000)

The *Disney* cases arise out of a decision by Michael Eisner in 1995 to hire Michael Ovitz as President of the Walt Disney Company. In 1995, Mr. Ovitz was a very successful Hollywood agent. He had a substantial interest in and operated Creative Artists Agency ("CAA"), the most powerful agency for Hollywood talent at that time. Mr. Ovitz was making \$20 - \$25 million a year in his operation of CAA, and, while Mr. Ovitz had little to no public company experience, Mr. Eisner was anxious to secure for Disney the services of his long time friend. Eisner's interest culminated in an employment agreement with Ovitz for five years beginning in October, 1995. The agreement provided lavish compensation to Ovitz in the form of salary, bonuses and stock options. The Ovitz employment agreement had been largely negotiated with Ovitz by two people, Michael Eisner and Irwin Russell (chair of Disney's Compensation Committee). It had been approved at a brief meeting of the Board's Compensation Committee on September 26, 1995. Although a compensation consultant had been retained to provide advice about the proposed compensation package, the consultant never met with the Disney Compensation Committee as a whole before the Compensation Committee approved the agreement with Ovitz.

In any event, the dream team of Ovitz and Eisner turned out to be a nightmare. After 14 months, Eisner had concluded that Ovitz simply didn't fit the Disney culture. Accordingly, Disney terminated Ovitz in December, 2006. The termination was done without any claim that it was warranted by any default by Ovitz under his agreement. As a result, Ovitz walked away with a severance package in excess of \$130 million after 14 months of service and after failing in his job. That payment created quite a stir and immediately prompted a shareholder derivative lawsuit.

For Disney, the litigation that followed was not pretty. While Disney had initial success at the trial court in affirming a dismissal of the alleged claims based largely on the business judgment rule, 731 A.2d 342 (1998), the Delaware Supreme Court ultimately remanded the case to the trial court to allow the plaintiffs to plead in greater detail the shortcomings of the process. When the plaintiffs did so, the trial court concluded that there were claims to be tried. The new facts pled raised substantial doubt as to whether the directors had exercised their business judgment in a meaningful and informed way. Plaintiffs' new Amended Complaint alleged that the hiring of Ovitz had essentially been engineered entirely by Michael Eisner, that Eisner had been personal friends of Ovitz for nearly 25 years, and that Disney's Compensation Committee and Board had merely rubber-stamped Eisner's decisions without any meaningful inquiry into the compensation package that had been provided to Ovitz. The key allegation in the complaint was that the package was structured in a way that provided Ovitz with more money if he were terminated without fault from his job than if he performed his job as president for the full five year term of the contract.

Based on these allegations, the Delaware Court of Chancery concluded that "plaintiffs' new complaint suggests that the Disney directors failed to exercise any business judgment and failed to make any attempt to fulfill their fiduciary duties to Disney and its stockholders." 825 A.2d 275, 278 (2003). The case proceeded to trial with the Disney directors facing potential liability for some or all of the \$130 million that had been paid to Ovitz. After 37 days in trial in the Delaware Court of Chancery, and the airing of embarrassing details about Michael Eisner, Michael Ovitz and others,<sup>3</sup> the Delaware trial court issued a 175

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<sup>3</sup> At trial, Eisner was portrayed as an imperious micro-manager, while plaintiffs argued that Ovitz "was a habitual liar who could not be trusted." Eisner also lavished Ovitz with early praise in the performance of his job yet turned on him quickly as a man who put a personal spin on every issue. Ovitz was also portrayed as an elitist who could not adjust to the Disney culture. For

page opinion. While that decision ultimately affirmed the decision of the Disney directors to both enter into and pay the \$130 million to Michael Ovitz, the favorable result came at great cost. In retrospect, those costs could have been avoided with greater attention to the procedural steps that should accompany the negotiation, review and approval of any lucrative, executive pay package.

What was unique about the Disney result is that the Disney directors faced potential personal liability in a circumstance in which no one could legitimately raise any issue about whether the directors had some economic self-interest in approving the Ovitz pay package. The most frequently cited basis for ignoring the business judgment rule and placing the directors at economic risk for an adverse money damages award is a showing that the directors had some economic interest in the outcome that poisoned the deliberative process. But that never occurred in *Disney*. In *Disney*, the court found that directors can be liable in damages for a breach of the duty of care if the breach amounted to a conscious disregard of the directors' duties to act with care. When that occurs, the court found that the directors have not acted in good faith, can be personally liable and the routine practice of insulating directors from personal liability for breach of the duty of care no longer works.<sup>4</sup>

### **III. THE KEY PROCESS IMPROVEMENTS**

Putting aside whether executives are overpaid, there is a need to assure that the process followed is fair, transparent and allows the directors to exercise informed business judgment in reviewing and approving the executive pay package. If this is done, the presumption in favor of the business judgment rule can become a powerful defense to the claims of angry shareholders. If it is not, directors may face the risk of substantial personal liability in hostile proceedings in which they are trying to defend the approval of lucrative pay packages. The following is a discussion of the "best practices" that should be followed to assure the full benefit of the business judgment rule.

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example, at the company retreat in Orlando, Ovitz refused to ride the Disney buses from event to event, enlisting a limousine at every point of travel. The public display of these contentions, and the related evidence, certainly cost Eisner and Ovitz personally.

<sup>4</sup> The Delaware code at 8 Del. C. § 102(6)(7) authorizes corporations to include in a corporation's Articles of Incorporation or Charter a provision that absolves directors of any personal liability for breach of duty of care. This "absolution" provision has exceptions for, among other things, breach of the duty of loyalty, acts or omissions not in good faith and any transaction in which a director received an improper, personal benefit.

**A. Use Independent Directors Who Have No Economic Interest in Negotiating or Approving the Executive Pay Package.**

The benefit of the business judgment rule is lost when the majority of the directors' business judgment appears to have been compromised by each director's self-interest. Under Delaware law, if the directors' decisions on an executive compensation are affected by self-interest, the plaintiff shareholders in a derivative action will ask the court to decide *de novo* whether the approval of the compensation package was entirely fair, both procedurally and substantively, to the shareholders. This is a very precarious position for directors to be in and it needs to be avoided. Neither the directors nor their lawyers want to be in a position in which they must argue to an elected judge or maybe even a jury that a \$25 million a year pay package for an executive is entirely fair to the shareholders. But this is precisely the position a lawyer may be in if the directors who negotiated and approved the pay package are not completely independent.

**B. Beware of any Appearance of Related Transactions.**

While it is usually true that the directors will receive no personal benefit as a result of their approval of an executive's compensation, plaintiffs' lawyers can be expected to argue that directors have received a *quid pro quo* from executives for the approval of the executive's pay package. If true, the director's decision will be set aside and the court will substitute its own sense of what is entirely fair in evaluating an executive's pay package.

*In Re Tyson Foods Inc., Consolidated Shareholders Litigation*, 919 A.2d 563, a post-Disney case from Delaware, illustrates the dangers of the potential related transaction. In that case, shareholders had brought a derivative action and a class action against Tyson Foods, Inc., its directors and officers, and its controlling shareholder. Defendants had filed a motion to dismiss invoking both a statute of limitations defense and a defense based on the business judgment rule. The complaint included specific allegations that certain directors' independence in approving compensation arrangements for current and former Tyson executives had been compromised. The complaint alleged that Tyson had purchased over \$10 million a year in cattle from one director and directed another \$600,000 to another director for research and development. Essentially, the complaint alleged that the directors' approval of the compensation arrangements and perquisites for the Tyson family had been purchased through these other transactions. As a result, the

directors' independence had been compromised, a motion to dismiss was denied and the director defendants faced potential liability for their approval of compensation packages for Tyson family members.

**C. Use an Independent Compensation Expert to Advise the Board.**

If the directors use an independent consulting expert to advise about executive compensation, the proper use of an outside expert can provide the directors with additional protection from liability. 8 Del. C. § 141(e).<sup>5</sup> Nevertheless, careful attention must be paid to the selection of the expert, and a written agreement with the outside consultant identifying specifically that the consultant will provide his or her independent advice on the subject of executive compensation to the Board is a necessity. Without such a written agreement, there is an opportunity for plaintiffs to argue that the consultant is merely advancing a position that the executives favor. This is because the outside consultant often must communicate extensively with executives of the company to gather information and formulate a recommendation. Shareholders may argue that this process means the consultant is not independent. To avoid this potential for confusion, a written agreement with the consultant should be used that requires the expert to provide his independent recommendation to the directors.

Finally, the independent expert should be required to communicate directly with the group of directors charged with legal responsibility for reviewing and approving the executive pay package. In *Disney*, a compensation consultant was retained but the consultant never met the entire Compensation Committee who approved the Ovitz pay package. This should occur and the meeting must involve a thorough discussion of the pros and cons of the proposed pay package and the consultant's recommendations. The failure to involve the expert with the entire Committee and to have the expert advise the Committee as a whole about the complete financial ramifications of the pay package became a significant problem for the director defendants in the *Disney* trial.

**D. Use Lawyers to Assure an Arms-Length Negotiation.**

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<sup>5</sup> Section 141(e) provides: "A member of the board of directors, or a member of any committee designated by the board of directors shall ... be fully protected in relying in good faith ... upon such information, opinions, reports ... presented to the corporation ... by any other person as to matters the member reasonably believes are within such person's professional or expert competence and who has been selected with reasonable care by or on behalf of the corporation."

To outsiders, there is reason to question whether executive compensation packages are a product of arms-length negotiations. The persons who negotiate these deals work together, see each other socially and often are friends. In *Disney*, Michael Eisner handled most of the negotiations with Michael Ovitz even though they had been friends for nearly 25 years.

One of the best ways to assure arms-length negotiations is to hire an outside lawyer to represent the Compensation Committee and a separate lawyer to represent the executives. This process also insulates in-house counsel from claims of conflict of interest, particularly inasmuch as the directors may be looking to in-house counsel for advice in a circumstance in which in-house counsel may have an economic interest in the compensation package negotiated for the executive or the executive team.

**E. Document the Deliberative Procedure.**

There is a tendency in corporate boardrooms to keep minutes of meetings very abbreviated. As a result when a court is examining the written record for evidence that the directors considered the pros and cons of the proposed executive package, there is often very little to document that. For this reason, it is beneficial to document in more detail than is normal the Board's and/or the Compensation Committee's review and approval of an executive pay package. In the end, it does not matter whether third parties might disagree with the directors' decision to approve an executive pay package. What matters is that the directors carefully considered the pros and cons and then exercised their business judgment.

The best defense to shareholder attacks on executive compensation packages remains the business judgment rule, but with the current widespread hostility to lucrative pay packages you can expect courts to scrutinize more carefully the process of director approval to see if business judgment was consciously and carefully applied. For that reason, lawyers need to assure that the steps outlined above are taken to protect that process and give it more integrity.



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**Representative Clients**

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- Atlantic Richfield Company
- Amazon.com
- Aramark
- Arco Alaska, Inc.
- AT&T Wireless
- Champion International
- Earle M. Jorgensen Company
- Exxon and ExxonMobil Corporation
- Georgia-Pacific
- Glacier Northwest
- Longview Fibre Company
- Lynden Transport
- Pendleton Woolen Mills
- The Port of Seattle
- Royal Bank of Canada
- Southland Corporation
- State of Washington
- Todd Shipyards
- U.S. Filter, Inc
- Significant Complex / Commercial Litigation

Mr. Cronin is a founding partner of the Corr Cronin law firm. Mr. Cronin was formerly co-chair of the Bogle & Gates litigation department from 1995 to 1999. Mr. Cronin is a Fellow in the American College of Trial Lawyers and has been named as one of the top business litigators in Seattle in every one of Seattle Magazine's top lawyer surveys since 2001. Mr. Cronin was one of the five named top business litigators in 2001 and 2003 and one of the four named in 2005 (his partner, Kelly Corr, was also named as a top business litigator in each survey). For 8 years in a row Mr. Cronin has been listed in the Best Lawyers in America. He has also been selected as a "Super Lawyer" on multiple occasions by Washington Law & Politics and has been named as one of the Top 100 Super Lawyers in the state.

**Practice / Experience**

Mr. Cronin's practice focuses on business litigation, representing both plaintiffs and defendants. He has considerable experience representing law firms, accounting firms, corporate officers and directors, and majority and minority stockholders in securities litigation, professional liability litigation, and corporate control disputes. During his career, Mr. Cronin has represented: Exxon Corp. in a large tax dispute with the State of Alaska involving a claim in excess of \$1 billion; Exxon and Arco Alaska in a major dispute with Chevron, Mobil and Phillips over the respective ownership interests in the Prudhoe Bay Oil Field, the largest oil field in North America; Georgia Pacific Corporation, AT&T Wireless, Pendleton Woolen Mills, Todd Shipyards and Champion International as plaintiffs in major insurance coverage disputes; and Amazon.com and AT&T Wireless in major contract disputes.

**Education / Background**

- J.D., University of Southern California Law School, 1975
  - >Order of the Coif
  - >Briedenbach Scholarship
  - >American Jurisprudence Award for Constitutional Law, 1974

- University of Oregon Law School, 1972-1973
  - >Oregon Law Alumni Scholarship

- B.A., cum laude, Brown University, 1970
  - Joined Bogle & Gates PLLC in 1978, and was a Member from 1983 to 1999
  - Associate Attorney, O'Melveny & Myers, Los Angeles, California, 1975-1978
  - Admitted to the Bar in California in 1975 and in Washington State in 1978

