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ARTICLES

CASH OF THE TITANS: ARBITRATING CHALLENGES TO EXECUTIVE COMPENSATION

Kenneth R. Davis[*]

I. INTRODUCTION

It is disturbing how brazenly corporate executives have grabbed ever-bigger compensation packages.[1] The facts are stunning. Steve Jobs's successor at Apple, Tim Cook, pulled in more compensation in 2011 than any other CEO in the United States.[2] The figure came to a whopping $378 million, a price tag that must have eaten up the profits from quite a few iPad sales.[3] Cook's pay cut in 2012 to a mere $4.2 million probably did not alarm him since the value of his 2011 stock grants had rocketed to $510 million.[4] Larry Ellison, CEO of Oracle, might have felt snubbed when his

* Professor of Law and Ethics, Fordham University Graduate School of Business; J.D., University of Toledo, School of Law, 1977; M.A., University of California, Long Beach, 1971; B.A., State University of New York at Binghamton, 1969. My thanks to Professor Brent Horton for his insightful comments, and to Jean, my wife, a magician of a librarian, who, with the tap of her finger, can transform murky databases into fonts of illumination.

1. Although this Article focuses primarily on CEO compensation, the pay levels of other high-ranking managers are also often inflated and are therefore a matter of concern. See *infra* Part II.C.1 for a discussion of *In re The Goldman Sachs Group, Inc. Shareholder Litigation,* where the compensation of managers was tied to a percentage of revenues. The result was a massive loss to a division of the company. *In re* Goldman Sachs Grp., Inc., S'holder Litig., No. 5215-VCG, 2011 WL 4826104, at *5 (Del. Ch. Oct. 12, 2011).

2. Scott Thurm, *Apple's Cook Tops the List of Highest-Paid CEOs*, WALL ST. J. (May 21, 2012, 1:49 PM), http://online.wsj.com/article/SB10001424052702304019404577416790548164260.html.

3. *See id.* (indicating that Cook's 2011 compensation package contained $1.8 million of annual salary and incentives and $376 million of restricted stock).

4. Peter Svensson, *Tim Cook Salary 2012: Apple CEO's Compensation Tops $4 Million*, HUFFINGTON POST (Dec. 27, 2012, 1:16 PM), http://www.huffingtonpost.com/2012/12/27/tim-cook-salary-2012_n_2370254.html.

company paid him a paltry $77.6 million in 2011,[5] but he must have recovered from his disappointment when Oracle's board of directors raised his pay to $96.2 million in 2012.[6] Lavish CEO pay is not limited to the technology sector. David E. Simon of Simon Property Group raked in $137.0 million in 2011,[7] Leslie Moonves of CBS scored a $68.4 million paycheck the same year,[8] and Brett Roberts of Credit Acceptance made a hefty $54.3 million in 2012.[9] These astronomical numbers are not aberrations. The average pay in 2012 for the CEOs of the S&P 500 companies was $12.3 million.[10]

Even more disconcerting, the upward march of CEO compensation has continued. CEO pay increased about 8% in 2012.[11] In 2011, the average pay for CEOs of the top 500 U.S. companies rose 15%.[12] That jump followed a 28% spike in 2010.[13] The prosperity that top management enjoys would not be so distressing if the wages of ordinary workers kept pace. Unfortunately, this is not so. Adjusted for inflation, workers saw their wages fall 2% in 2011.[14] Taking a broader view is even more sobering. From 1978–2011, the pay of workers rose a modest 5.7%, while the compensation of CEOs ballooned more than 725%.[15] In 1978, CEOs on average earned a reasonable 26.5 times as much as ordinary workers.[16] By 2012 this ratio had catapulted to 354 to 1.[17]

The public's uproar over excessive executive compensation is understandable. The system seems rigged against the average worker. To people who live from paycheck to paycheck, the scale of CEO pay is incomprehensible. People wonder how much value CEOs bring to companies, especially in the aftermath of the financial crisis

5. *Larry Ellison, Oracle CEO, Gets $21 Million Pay Raise Despite Company's Stock Decline*, HUFFINGTON POST (Sept. 22, 2012, 2:09 PM), http://www.huffingtonpost.com/2012/09/22/larry-ellison-oracle-ceo-pay-raise_n_1905193.html.

6. *See id.* (noting that almost all of Ellison's total compensation in the fiscal year 2011 was in stock options).

7. Nathaniel Popper, *C.E.O. Pay, Rising Despite the Din*, N.Y. TIMES, June 17, 2012, at BU1 (indicating that $132 million of the compensation package was a one-time reward in the form of a stock package to be distributed over the course of eight years).

8. *Id.*

9. Jordan Robertson, *Compensation Kings: Top 15 U.S. CEOs*, BLOOMBERG (July 11, 2013, 7:22 PM), http://www.bloomberg.com/slideshow/2013-07-11/compensation-kings-top-15-u-s-ceos.html#slide9.

10. *Executive Paywatch: Trends in CEO Pay at S&P 500 Index Companies*, AFL-CIO, http://www.aflcio.org/Corporate-Watch/CEO-Pay-and-You/Trends-in-CEO-Pay (last visited Feb. 23, 2014).

11. Matt Krantz & Barbara Hansen, *Back in the High (Pay) Life Again: CEOs' Median Pay Rose 8% in 2012, to $9.7 Million*, USA TODAY, Mar. 28, 2013, at 1B.

12. Bonnie Kavoussi, *CEO Pay Grew 127 Times Faster than Worker Pay over Last 30 Years: Study*, HUFFINGTON POST (July 4, 2012, 11:03 AM), www.huffingtonpost.com/2012/05/02/ceo-pay-worker-pay_1471685.html. This article was based on a report of GMI Ratings, which was reported in *The Guardian*. *Id.*

13. *Id.*

14. *Id.*

15. *Id.*

16. Jennifer Liberto, *CEOs Earn 343 Times More than Typical Workers*, CNNMONEY (Apr. 20, 2011, 7:46 AM), http://money.cnn.com/2011/04/19/news/economy/ceo_pay/index.htm.

17. *See Executive Paywatch*, *supra* note 10 (reporting average compensation of the CEOs of the S&P 500 companies).

when the reckless risk-taking of many of the most respected and highly paid CEOs brought their companies and the country to the brink of financial ruin.[18]

The question is how to correct the inequities of corporate pay. Reformers have proposed numerous solutions ranging from tax policy aimed at incentivizing lower executive pay to mandatory say-on-pay proxy votes to enhanced proxy disclosures.[19] None of these proposed solutions has worked.[20]

Litigation is another approach for controlling excessive executive compensation. Faced with skyrocketing compensation packages for high-level managers, shareholders of both closely held and publicly traded companies have initiated derivative suits challenging the plundering of their corporations. This tactic has also failed.[21] A web of substantive law and procedural rules that protect officers and directors dooms most shareholder derivative claims.[22] The principal culprit is the business judgment rule.[23] Directors are not liable for breach of fiduciary duty to a corporation unless gross negligence, bad faith, or self-dealing tainted their decisions, or the decision had no rational business purpose.[24] If a plaintiff does not meet this burden, the business judgment rule will prevent a judge from even looking at the magnitude and justification for a manager's compensation.[25] Applying this rule, courts routinely reject challenges

18. *See* Kara Scannell, *Policy Makers Work to Give Shareholders More Boardroom Clout*, WALL ST. J., Mar. 26, 2009, at B4 (stating the argument that the excessive risk-taking of CEOs sparked the financial crisis).

19. *See* Kenneth R. Davis, *Taking Stock–Salary and Options Too: The Looting of Corporate America*, 69 MD. L. REV. 419, 424 (2010) (describing various legislative and regulatory policy proposals designed to curb excessive executive compensation).

20. *See id.* (describing these corporate governance policy proposals as "either undesirable or ineffective").

21. *See* Blake H. Crawford, *Eliminating the Executive Overcompensation Problem: How the SEC and Congress Have Failed and Why the Shareholders Can Prevail*, 2 J. BUS. ENTREPRENEURSHIP & L. 273, 283–84 (2009) (observing that courts have been deferential to directors in cases where shareholders have challenged excessive compensation agreements); Davis, *supra* note 19, at 451–62 (discussing how the business judgment rule defeats cases challenging excessive executive compensation and how the presuit demand rule for shareholder derivative suits leads to dismissals before shareholders have had the opportunity to present the facts constituting excessive executive compensation to the court).

22. See *infra* Section II for a discussion of the business judgment rule and other legal barriers to lawsuits challenging excessive executive compensation.

23. *See* Rales v. Blasband, 634 A.2d 927, 933 (Del. 1993) (referring to the "powerful presumptions" of the business judgment rule); Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (characterizing the business judgment rule as a "presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company"); David Rosenberg, *Supplying the Adverb: The Future of Corporate Risk-Taking and the Business Judgment Rule*, 6 BERKELEY BUS. L.J. 216, 217 (2009) (describing the business judgment rule as creating a "very high threshold" that shields corporate directors from "their most disastrous decisions").

24. *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 949 (Del. 1985) (stating that a hallmark of the business judgment rule is that a court will not substitute its judgment for that of the board if the latter's decision can be attributed to "any rational business purpose" (quoting Sinclair Oil Co. v. Levien, 280 A.2d 717, 720 (Del. 1971))); Andrew S. Gold, *A Decision Theory Approach to the Business Judgment Rule: Reflections on* Disney, *Good Faith, and Judicial Uncertainty*, 66 MD. L. REV. 398, 433–36 (2007) (explaining that the business judgment rule is rebutted (1) in duty of care cases with allegations or proof of gross negligence, (2) in duty of loyalty cases with a showing of conflict of interest, and (3) in duty of good faith cases with a showing of intentional dereliction of corporate responsibilities).

25. *See, e.g.*, Cohen v. Ayers, 596 F.2d 733, 742–43 (7th Cir. 1979) (affirming summary judgment for

to outrageous compensation packages.[26]

Arbitration is an efficient method of alternative dispute resolution that may provide an effective means for reversing this travesty. The parties to executive compensation disputes may select arbitrators who have the requisite expertise.[27] In addition, arbitration is economical, dispensing with many of the costly and time-consuming procedural formalities of litigation.[28] Perhaps most importantly, arbitrators are generally not bound by procedural or substantive law.[29] They may rely on their own sense of justice, fashioning rules of decision based on fairness rather than formalism.[30] The flexibility to diverge from rules of law means that, when confronted with a challenge to excessive executive compensation, arbitrators may ignore the burdensome business judgment rule and other similar laws that make judicial review of even the most outrageous compensation packages a virtual impossibility. Free of these constraints, arbitrators can evaluate challenges to outlandish compensation packages. Guided by their experience and their sense of justice, they might sustain challenges that judges would reject.

The shareholder derivative suit is the mechanism for challenging excessive executive compensation. In Section II, this Article examines the procedural and substantive rules that stymie derivative suits, including the business judgment rule. Another barrier is the so-called "demand rule." This rule requires shareholders, as a precondition to commencing a derivative suit, to make a demand on the board of directors to initiate the suit on behalf of the corporation.[31] In certain instances, the law excuses demand on the board, but courts excuse demand only when the shareholders overcome the business judgment rule or show that a majority of directors have a personal stake in the transaction.[32] Once shareholders have met the requirements of the demand rule and have properly commenced a derivative suit, companies often appoint

Sears corporation directors charged in derivative suit with improperly restructuring stock option plan for their personal benefit and the benefit of key employees).

26. See *infra* Part II.B for a discussion of cases where the business judgment rule scuttled claims alleging excessive if not egregious executive compensation arrangements.

27. *See* Edward Brunet & Jennifer J. Johnson, *Substantive Fairness in Securities Arbitration*, 76 U. CIN. L. REV. 459, 462 (2008) (explaining that many scholars define arbitration as a private method of dispute resolution where experts render decisions based on proof submitted by the disputing parties).

28. *See* Robert D. Crane, *Arbitral Freedom from Substantive Law*, 14 ARB. J. 163, 163 (1959) (listing the benefits of commercial arbitration as "flexibility, speed, economy, expertise and privacy").

29. *See, e.g.*, Perini Corp. v. Greate Bay Hotel & Casino, Inc., 610 A.2d 364, 396 (N.J. 1992) (emphasizing that parties arbitrate to avoid the application of substantive law); Silverman v. Benmor Coats, Inc., 461 N.E.2d 1261, 1266 (N.Y. 1984) (noting that unless an arbitration clause provides otherwise, arbitrators may rely on their sense of fairness rather than substantive law).

30. *See, e.g.*, Sapp v. Barenfeld, 212 P.2d 233, 239 (Cal. 1949) (affirming that arbitrators may resolve disputes based on their sense of fairness and may reject claims that a party might have successfully brought in court); Murray S. Levin, *The Role of Substantive Law in Business Arbitration and the Importance of Volition*, 35 AM. BUS. L.J. 105, 124–25 (1997) (cataloguing cases in several jurisdictions where courts have adhered to the principle that arbitrators may reject otherwise controlling legal rules and rely instead on their sense of justice and equity).

31. Ann M. Scarlett, *Imitation or Improvement? The Evolution of Shareholder Derivative Litigation in the United States, United Kingdom, Canada, and Australia*, 28 ARIZ. J. INT'L & COMP. L. 569, 578 (2011).

32. *Id.* at 578–79.

special litigation committees (SLCs) ostensibly to evaluate the merits of the suit.[33] It is not surprising that SLCs frequently move to dismiss derivative suits.[34] Courts tend to defer to SLCs, and some courts apply the business judgment rule when deciding such motions.[35]

Section III discusses justifications for the business judgment rule. One justification is that judges are not qualified to make complex business decisions. Another justification is that by interfering with decisions made by corporate management, judges discourage reasonable corporate risk-taking. A final justification is that state intrusions into private enterprise threaten not only economic freedom but also political freedom.

Section IV discusses why the justifications for the business judgment rule do not apply to cases challenging executive compensation. First, directors, who make executive pay decisions, are subject to conflicts of interest and social pressures that often skew their decisions. Second, decisions of how much to pay executives are not highly complex; judges are fully capable of addressing such questions. Third, dispensing with the business judgment rule in executive compensation cases would not discourage reasonable corporate risk-taking because shareholders in such cases merely challenge the magnitude of executive pay rather than policies or strategies entailing corporate risk-taking.

Section V shows the advantages to arbitrating, rather than litigating, challenges to executive compensation. The parties to an arbitration agreement may fashion the procedures to ensure a level of efficiency not attainable in litigation. They may dispense, for example, with copious discovery and motions practice that bog down litigation. They will also select arbitrators because of their expertise. Arbitrators of executive compensation disputes would therefore be likely to come to well-reasoned decisions. Furthermore, as nonjudicial decisionmakers, arbitrators are not agents of the state who might intrude into the sphere of private enterprise. Rather, arbitrators are agents of the disputing parties. Unlike judges, arbitrators are therefore not required to apply the rules of substantive law. If challenges to executive compensation were arbitrated, awards could avoid the undesirable consequences of the business judgment rule, the demand rule, and other legal impediments to challenges to excessive executive compensation. Based on their expertise and sense of justice, arbitrators could review the magnitude of and rationale for compensation packages.

Section VI turns to the threshold issue of whether derivative suits are arbitrable and concludes that they are. This Section also explores strategies that shareholders might employ to assure that their challenges to excessive executive pay will be arbitrated rather than litigated. One strategy is to amend the articles of incorporation; the other is to pass a bylaw.

Concluding with Section VII, this Article encourages shareholders to pursue these strategies. Corporate officers and directors will oppose proposals that threaten the

33. *Id.* at 579.

34. *See id.* (indicating that this decision by SLCs is often based on the "recommendation that continuing the litigation is not in the best interests of the corporation").

35. *See id.* (observing that "[m]ost courts find that the business judgment rule defense protects the committee's recommendation and therefore grant the motion to dismiss" (footnote omitted)).

upward pay spiral, but if shareholders are docile, pay levels will move perpetually in one direction. Inevitably, that direction is up.

II. LEGAL BARRIERS TO LAWSUITS CHALLENGING EXECUTIVE COMPENSATION

Several principles of law scuttle challenges to excessive executive compensation. Foremost among these principles is the business judgment rule.[36] Unless rebutted, this rule operates as a defense to a lawsuit against officers or directors, preventing judges from even considering whether a pay package is reasonable compensation for services rendered or an unconscionable transfer of wealth.[37] Another barrier to cases challenging excessive executive compensation is the demand rule, which establishes preconditions for the initiation of a shareholders' derivative suit.[38] As shown below, the demand rule incorporates the onerous business judgment rule.[39] Where shareholders meet the demand rule and commence derivative suits, they often face motions to dismiss initiated by SLCs. Courts are typically deferential to such motions, sometimes reverting once again to the business judgment rule.[40] Shareholders frequently allege corporate waste as the basis for challenging excessive executive compensation. It is regrettable that the standard for alleging and proving corporate waste is yet another repackaged manifestation of the business judgment rule.[41]

A. The Contours of the Business Judgment Rule

Officers and directors have fiduciary duties of care, loyalty, and good faith to their corporation and its shareholders, though courts often view the duty of good faith as a subset of the duty of loyalty.[42] A creature of common law,[43] the business judgment rule

36. See *infra* Part II.A for an outline of the requirements of the business judgment rule.

37. See *infra* Part II.B for a discussion of how courts have applied the business judgment rule as a defense in cases challenging excessive executive compensation.

38. See *infra* Part II.C for an analysis of the requirements of the demand rule and a discussion of its application in executive compensation cases.

39. See *infra* Part II.C.2 for an examination of the relationship between the business judgment rule and the demand rule.

40. See *infra* Part II.D for a review of the three principal standards applied to decide SLC motions to dismiss shareholder derivative suits.

41. See *infra* Part II.E for a discussion of the standards for alleging and proving corporate waste and their application in executive compensation cases.

42. *See* Lyondell Chem. Co. v. Ryan, 970 A.2d 235, 239–40 (Del. 2009) (treating an act of bad faith as a violation of the duty of loyalty); Anne Tucker Nees, *Who's the Boss? Unmasking Oversight Liability Within the Corporate Power Puzzle*, 35 DEL. J. CORP. L. 199, 209 (2010) (pointing out that courts consider the duty of good faith to be included in the duty of loyalty).

43. The Revised Model Business Corporation Act (RMBCA) prescribes the duties of corporate directors. The most recent version of the RMBCA provides as follows: "Each member of the board of directors, when discharging the duties of a director, shall act: (1) in good faith, and (2) in a manner the director reasonably believes to be in the best interests of the corporation." MODEL BUS. CORP. ACT § 8.30(a) (2011). The Official Comment on this section states: "The elements of the business judgment rule and the circumstances for its application are continuing to be developed by the courts. Section 8.30 does not try to codify the business judgment rule or to delineate the differences between that defensive rule and the section's standards of director conduct." *Id.* § 8.30 cmt.

shields officers and directors from claims alleging a breach of these duties.[44] The rule establishes a rebuttable "presumption that in making a business decision the [officers or] directors of a corporation acted on [1] an informed basis, [2] in good faith and in [3] the honest belief that the action taken was in the best interests of the company."[45]

If the plaintiff rebuts the presumption of the business judgment rule, the burden of proof shifts to the defendant who must show that the challenged acts or transactions were entirely fair.[46] Rebutting the presumption, however, is no easy task. Plaintiffs alleging a breach of the duty of care must show that the challenged corporate action resulted from gross negligence.[47] To rebut the application of the business judgment rule in a breach of loyalty case, the plaintiff must show that a majority of directors either lacked independence or were self-interested when making the decision.[48] A showing of intentional dereliction of duty will rebut the presumption good faith.[49] Although the rule operates sensibly in many contexts by protecting officers and directors from disgruntled shareholders who seek to intrude into corporate affairs, it creates a powerful defense for directors who, at the expense of the corporation, lavish

44. *See* Daniel J. Morrissey, *The Path of Corporate Law: Of Options Backdating, Derivative Suits, and the Business Judgment Rule*, 86 OR. L. REV. 973, 974 (2007) (noting that the business judgment rule operates as a defense to charges that officers and directors have violated their duty of due care).

45. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984); *see also* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 360 (Del. 1993) (instructing that the business judgment rule "operates as both a procedural guide for litigants and a substantive rule of law" (quoting Citron v. Fairchild Camera & Instrument Corp., 569 A.2d 52, 64 (Del. 1989))).

46. CDX Liquidating Trust v. Venrock Assocs., 640 F.3d 209, 215 (7th Cir. 2011); *see also* Wahlcometroflex, Inc. v. Baldwin, 991 A.2d 44, 48 (Me. 2010) (requiring defendants to prove the challenged transaction was "entirely fair" once the business judgment rule is rebutted); *In re* Walt Disney Co. Deriv. Litig., 906 A.2d 27, 52 (Del. 2006) (explaining that if the plaintiff rebuts the presumptions of the business judgment rule, "the burden then shifts to the director defendants to demonstrate that the challenged act or transaction was entirely fair to the corporation and its shareholders").

47. *See, e.g.*, *Disney*, 906 A.2d at 53 (requiring plaintiff alleging a violation of the duty of care to show at trial that directors acted with gross negligence).

48. *See, e.g.*, *Cede & Co.*, 634 A.2d at 361, 364 (finding that, "[to] rebut the [business judgment] rule, a shareholder plaintiff assumes the burden of providing evidence that directors, in reaching their challenged decision, breached any one of the *triads* of their fiduciary duty—good faith, loyalty or due care," and noting that the presumption of loyalty is rebutted by a showing that self-interest "infected the board's decision"); Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983) (stating that "[t]here is no 'safe-harbor' for such divided loyalties in Delaware"); *In re* Lear Corp. S'holder Litig., 967 A.2d 640, 655 (Del. Ch. 2008) (holding that to rebut the presumption of the business judgment rule in a merger case, the complaint, where alleging breach of the duty of loyalty, must plead particularized facts showing that the directors acted in bad faith); *In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 751 (Del. Ch. 2005) (stating that "there is no safe-harbor for divided loyalties in Delaware"); Orman v. Cullman, 794 A.2d 5, 22 (Del. Ch. 2001) (stating that the business judgment rule can be rebutted when plaintiff alleges that the board was interested in the transaction or was unable to evaluate the merits of the transaction objectively); Security Police & Fire Prof'ls Ret. Fund v. Mack, 940 N.Y.S.2d 609, 614 (N.Y. App. Div. 2012) (holding that, to rebut the business judgment rule's presumption of loyalty, plaintiff must show the directors in question consciously disregarded their duties); Robert Sprague & Aaron J. Lyttle, *Shareholder Primacy and the Business Judgment Rule: Arguments for Expanded Corporate Democracy*, 16 STAN. J.L. BUS. & FIN. 1, 15 (2010) (linking the duty of good faith to the duty of loyalty and summarizing the standards for rebutting the presumptions of the business judgment rule).

49. *See Disney*, 906 A.2d at 66 (stating that an intentional dereliction of duty is a "non-exculpable, nonindemnifiable violation of the fiduciary duty to act in good faith").

unimaginable wealth on corporate executives.[50]

B. *The Business Judgment Rule as a Defense to Challenges to Excessive Executive Compensation*

Based on the presumption protecting the decisions of corporate directors, courts routinely reject challenges to excessive executive compensation without examining the terms of the compensation packages.[51] Courts will even ignore the misfeasance of a director or groups of directors who, without examining the terms of an executive compensation package, gave the package their blessing.[52] The business judgment rule therefore operates as a license for directors to stuff the wallets of undeserving executives with heaps of corporate cash.

Perhaps the most notorious executive compensation case is *In re the Walt Disney Company Derivative Litigation*.[53] After suffering a heart attack, Michael Eisner, Disney's president and CEO, decided, with the approval of the company's board of directors, to find a successor.[54] A longtime friend of Eisner, Michael Ovitz was Eisner's choice to take the reins of the company.[55] Eisner along with Irwin Russell, chairman of Disney's compensation committee, entered into negotiations with Ovitz.[56] These negotiations culminated in a proposed five-year employment contract whereby Ovitz would receive total annual compensation of $23.6 million, or $24.1 million, assuming a two-year renewal.[57]

Disney's four-person compensation committee had a one-hour meeting at which it considered the proposed Ovitz employment contract among other agenda items.[58] Disney's compensation consultant did not attend.[59] Raymond Watson, a member of the committee, testified that he distributed a spreadsheet with relevant facts at the meeting,

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50. Another barrier to shareholder recovery arises from exculpation provisions in corporate charters. Delaware law permits articles of incorporation to exculpate directors for breach of the duty of care but not for breach of the duty of good faith. Del. Code Ann. tit. 8, § 102(b)(7) (West 2014).

51. *See, e.g.*, Cohen v. Ayers, 596 F.2d 733, 742–43 (7th Cir. 1979) (affirming summary judgment for Sears corporation directors charged in derivative suit with improperly restructuring stock option plan for their personal benefit and the benefit of key employees); Gagliardi v. Trifoods Int'l, Inc., 683 A.2d 1049, 1054–55 (Del. Ch. 1996) (dismissing shareholder derivative suit alleging excessive compensation claim on the ground that the allegations did not satisfy the business judgment rule); Mlinarcik v. E.E. Wehrung Parking, Inc., 620 N.E.2d 181, 183–85 (Ohio Ct. App. 1993) (dismissing shareholder derivative action alleging that two managers' annual salaries totaling $18,000 for minimal work was unreasonable in view of expert testimony that the value of such services was between $567 and $2,000). *But see* NECA-IBEW Pension Fund *ex rel.* Cincinnati Bell, Inc. v. Cox, No. 1:11-cv-451, 2011 WL 4383368, at *3–4 (S.D. Ohio Sept. 26, 2011) (declining to dismiss a shareholder derivative suit based on the business judgment rule where the complaint raised the plausible claim that multimillion dollar bonuses violated the company's performance compensation policy).

52. See *infra* notes 53–92 and accompanying text for a discussion of the *Disney* and *Grasso* cases.

53. 906 A.2d 27 (Del. 2006).

54. *Disney*, 906 A.2d at 36.

55. *Id.*

56. *Id.* at 36–37.

57. *Id.* at 38.

58. *Id.* at 40.

59. *Id.*

though two committee members testified that they had no recollection of seeing a spreadsheet or of discussing the excessive so-called "no-fault termination" provision that later incited shareholder outrage culminating in litigation.[60] After approval by the compensation committee, the board of directors, without being informed that Disney's general counsel and CFO had objected to the proposal, rubber stamped the agreement.[61]

Within one year of Ovitz's ascension to the presidency of Disney, the board of directors grew dissatisfied with his performance and came to believe that, for the good of the company, his termination was necessary.[62] Shortly thereafter, Eisner wrote a letter to Russell and Watson detailing Ovitz's failures as president and Eisner's lack of trust in him.[63] Only fourteen months into his term as president, Ovitz was terminated.[64] Under the provisions of the "no fault termination" clause, Ovitz received a $130 million severance payout.[65]

Shareholders alleged in a derivative suit that Ovitz's extravagant payout constituted corporate waste and that Disney's directors breached their fiduciary duties of due care and good faith.[66] Creditable if not persuasive on their face, these claims were overmatched by the muscular business judgment rule. Though observing that Disney's compensation committee did not follow "best practices"—a gross understatement if ever there was one—and that the record documenting the compensation committee's knowledge of the magnitude of the payout "le[ft] much to be desired," the Delaware Supreme Court held that the compensation committee satisfied the minimal requirements of the business judgment rule.[67]

This disturbing decision is not an aberration. In *Spitzer v. Grasso*,[68] a divided New York Court of Appeals rejected a challenge to a stupefying $187.5 million compensation package, which the New York Stock Exchange (NYSE), then a not-for-profit corporation, bestowed on its president, Richard Grasso.[69] Grasso's 2003 compensation package was composed of a $139.5 million lump sum payment to be made that year and another $48 million to be paid over the next four years.[70] Even

60. *Id.* at 40 n.13. At trial, two directors, Sidney Poitier and Ignacio Lorenzo, testified that they did not recall seeing any spreadsheets at the compensation committee meeting. *Id.* Corroborating this testimony, the minutes of the meeting did not mention the terms of a potential $130 million payout. *Id.* The Chancery Court, however, discounted this evidence, surmising that Poitier's and Lorenzo's lack of recollection was likely the result of faulty memories hampered by the passage of nine years. *Id.*

61. *Id.* at 41.

62. *Id.* at 42.

63. *Id.* at 43.

64. *Id.* at 35.

65. *Id.*

66. *Id.* at 46. After a bench trial, the Delaware Court of Chancery entered judgment for the defendants. *Id.* at 35.

67. *Id.* at 56–58. The court also ruled that the Disney directors had not violated their duty of good faith because they had not consciously and intentionally disregarded their responsibilities. *Id.* at 62. See Jennifer S. Martin, *The House of Mouse and Beyond: Assessing the SEC's Efforts to Regulate Executive Compensation*, 32 DEL. J. CORP. L. 481, 499–503 (2007), for a criticism of the outcome of the *Disney* case.

68. 893 N.E.2d 105 (N.Y. 2008).

69. *Grasso*, 893 N.E.2d at 106, 110.

70. *Id.* at 106.

before this giveaway, Grasso's compensation exceeded the NYSE 1999 compensation benchmark by 64%, the NYSE 2000 benchmark by 141%, and the NYSE 2001 benchmark by 65%.[71] Perhaps the most startling allegation was that the value of Grasso's employment benefits from 2000 to 2002 nearly equaled the NYSE's total net income for that period.[72]

Instituted by the New York State Attorney General, the complaint alleged that Grasso engaged in a pattern of manipulation, deceit, and undue influence.[73] According to the complaint, Grasso had sole authority to assign directors to the very compensation committee that awarded him this enormous sum.[74] More than willing to misuse his position to steamroll approval of his compensation packages during his tenure as NYSE's CEO, Grasso allegedly confronted one board member who had dared question his proposed compensation for 2000.[75] This board member felt intimidated because, as a NYSE member, he was subject to Grasso's regulatory authority.[76] Furthermore, Frank Z. Ashen, the human resources director who supplied the board with information bearing on Grasso's proposed compensation packages, admitted that the information he provided to the board was "incomplete, inaccurate and misleading."[77] For example, he falsely told the board that $18.5 million of the $139.5 payment under the 2003 agreement was already vested.[78]

The complaint also alleged that the procedures leading to adoption of Grasso's compensation package were infected with wrongdoing.[79] Several board members expressed disapproval of Grasso's proposed 2003 compensation package.[80] Because of this opposition, Grasso informed at least five board members that his proposed compensation package would not be on the agenda of the committee's August 2003 meeting.[81] The proposed compensation package was similarly omitted from the agenda of the August 2003 meeting of the board of directors.[82] In response to this omission, several committee members and board members, as well as the NYSE's compensation consultant and attorney, announced that they would not be attending these meetings.[83] Because opponents, both declared and potential, to Grasso's compensation package were absent from the compensation committee meeting, those in attendance, apparently under Grasso's influence, added the proposed compensation package to the agenda at

71. *Id.*

72. Complaint ¶ 34, Spitzer v. Grasso, 816 N.Y.S.2d 863 (N.Y. Sup. Ct. 2006) (No. 401620/04); *see also* Joseph E. Bachelder III, *Executive Compensation; New York Courts Dismiss* 'Grasso' *Compensation Case*, N.Y. L.J., Aug. 27, 2008, *available at* http://blogs.law.harvard.edu/corpgov/2008/08/28/new-york-courts-dismiss-grasso-compensation-case/ (summarizing the allegations of the complaint).

73. Complaint, *supra* note 72, ¶¶ 25, 52.

74. *Id.* ¶¶ 5, 25.

75. *Id.* ¶ 25.

76. *Id.*

77. *Id.* ¶ 22.

78. *Id.* ¶ 21.

79. *Id.* ¶¶ 15–18.

80. *Id.* ¶ 142.

81. *Id.*

82. *Id.*

83. *Id.* ¶¶ 144–47.

the last minute.[84] The committee, as one might predict, approved the proposal.[85] The proposal then went to the board for approval on the very same day.[86] The directors who attended that board meeting did not have the opportunity to read the proposal before the meeting,[87] and few, if any, of them understood the proposal's complex terms.[88] Nevertheless, the board approved the proposal.[89]

These shocking allegations of grossly excessive compensation, manipulation, and deceit surely raised the inference that Grasso's 2003 compensation agreement resulted from improper tactics. Nevertheless, Grasso moved to dismiss the four common law causes of action asserted in the Attorney General's complaint.[90] New York Supreme Court Justice Ramos denied the motion, observing that "[t]he investing community relies on the integrity of the market as well as the NYSE's governance and regulatory structure which serves it."[91] The New York Court of Appeals, however, thought otherwise. Acknowledging that Grasso's compensation package appeared "unreasonable . . . on its face," the court held that the Attorney General's claims could not overcome the business judgment defense.[92]

C. The Demand Rule for Shareholder Derivative Suits

Several onerous pleading requirements frustrate shareholders who wish to initiate derivative lawsuits challenging excessive executive compensation.[93] To appreciate the wholly inappropriate way that these pleading requirements may, at the initial stage of a shareholder derivative lawsuit, stop it before it has even begun, one must understand the preconditions for instituting such a lawsuit. As a general rule, a corporation's board of directors has sole authority to institute lawsuits on behalf of the corporation.[94] A complaining shareholder who wishes to commence a suit on behalf of the corporation

84. *Id.* ¶ 145.

85. *Id.*

86. *Id.* ¶ 146.

87. *Id.* ¶¶ 148, 151.

88. *Id.* ¶ 152.

89. *Id.* ¶ 155.

90. These causes of action alleged (1) constructive trust, (2) payment had and received, (3) the right to restitution, and (4) violation of the rule prohibiting corporations from making loans to its officers. People *ex rel.* Spitzer v. Grasso, 893 N.E.2d 105, 107 (N.Y. 2008).

91. People *ex. rel.* Spitzer v. Grasso, 816 N.Y.S.2d 863, 871 (N.Y. Sup. Ct. 2006), *rev'd*, 836 N.Y.S.2d 40 (N.Y. App. Div. 2007), *aff'd*, 893 N.E.2d 105 (N.Y. 2008).

92. *Grasso*, 893 N.E.2d at 110. The New York Court of Appeals affirmed the order of the appellate division, which had reversed Justice Ramos's ruling on the ground that the Attorney General lacked authority to sue for common law claims. People *ex rel.* Spitzer v. Grasso, 836 N.Y.S.2d 40, 53 (N.Y. App. Div. 2007). Justice Mazzarelli dissented, asserting that the Attorney General had *parens patriae* to pursue the common law causes of action alleged in the complaint. *Id.* at 56 (Mazzarelli, J., dissenting).

93. *See, e.g.*, Plumbers Local No. 137 Pension Fund v. Davis, No. 03:11-633-AC, 2012 WL 104776, at *8 (D. Or. Jan. 11, 2012) (dismissing complaint challenging excessive executive compensation for failure to comply with the particularized pleading requirement of the demand rule).

94. *In re* Citigroup S'holder Derivative Litig., 964 A.2d 106, 120 (Del. Ch. 2009); *see also* Jessica M. Erickson, *Overlitigating Corporate Fraud: An Empirical Explanation*, 97 IOWA L. REV. 49, 55–56 (2011) (explaining that "corporate officers and directors . . . normally decide whether corporations should file lawsuits").

must therefore make a demand on the board to do so.[95] Demand is excused, however, where it would be futile.[96] Under Delaware law, the shareholders are excused from making demand on the board if the shareholders can allege particularized facts creating a reasonable doubt that (1) the directors were disinterested and independent, or (2) the challenged transaction was the product of a valid business judgment.[97] As applied by the courts, this burden on the plaintiff-shareholders is unreasonable, and it often borders on the absurd.[98]

1. Pleading Lack of Director Disinterest and Independence

In *In re The Goldman Sachs Group, Inc. Shareholders Litigation*,[99] the plaintiff-shareholders challenged the executive compensation structure instituted by Goldman's board because the structure based compensation on a percentage of net revenue, which, according to the plaintiffs, encouraged management to pump up revenues by engaging

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95. Scarlett, *supra* note 31, at 578.

96. *Citigroup*, 964 A.2d at 120. The RMBCA proposes a universal demand requirement. Section 7.42 of the RMBCA provides:

> No shareholder may commence a derivative proceeding until:
>
> (1) a written demand has been made upon the corporation to take suitable action; and
>
> (2) 90 days have expired from the date delivery of the demand was made unless the shareholder has earlier been notified that the demand has been rejected by the corporation or unless irreparable injury to the corporation would result by waiting for the expiration of the 90-day period.

MODEL BUS. CORP. ACT § 7.42 (2011).

97. *Citigroup*, 964 A.2d at 120.

98. *See, e.g.*, *Plumbers Local No. 137*, 2012 WL 104776, at *2, *7–8 (dismissing complaint for failure to satisfy the presuit demand requirement in a derivative suit challenging executive compensation increases of approximately 60% to 160% during a period when return to shareholders was negative 7%); Grimes v. Donald, 673 A.2d 1207, 1211, 1220 (Del. 1996) (affirming dismissal of shareholders' derivative suit challenging board approval of the CEO's termination provision, which included a salary continuation clause and the grant of $60 million in stock units); Cooke v. Oolie, No. CIV. A. 11134, 1997 WL 367034, at * 7–8, *12 (Del. Ch. June 23, 1997) (dismissing claims against directors for issuing themselves warrants where the plaintiff-shareholders failed to make demand on the board of directors); Mona v. Mona Elec. Grp., Inc., 934 A.2d 450, 469–70 (Md. Ct. Spec. App. 2007) (rejecting complaint for failure to meet the demand rule where complaint alleged that the CEO of a closely held corporation abused his authority by manipulating the board into increasing his annual compensation from approximately $400,000 to $1,000,000 over a five-year period); Jannett v. Gilmartin, No. HNT-L-341-05, 2006 WL 2195819, at *7 (N.J. Super. Ct. Law Div. July 21, 2006) (dismissing shareholder derivative suit for failure to make demand in case alleging excessive executive compensation and golden parachutes during time of Merck pharmaceutical company's poor financial performance); Sec. Police & Fire Prof'ls of Am. Ret. Fund v. Mack, 917 N.Y.S.2d 527, 532, 544 (N.Y. Sup. Ct. 2010) (dismissing shareholders' derivative suit against Morgan Stanley due to lack of presuit demand even though the company paid $14.4 billion in total compensation to employees in a year when it lost $907 million), *aff'd*, 940 N.Y.S.2d 609 (N.Y. App. Div. 2012). *But see* Ryan v. Gifford, 918 A.2d 341, 354, 361 (Del. Ch. 2007) (excusing the plaintiff in a shareholder derivative suit from the demand requirement because the board intentionally violated the company's stock option plan by backdating the option grant to alter the exercise price); *In re* Tyson Foods, Inc. Consol. S'holder Litig., 919 A.2d 563, 584 (Del. Ch. 2007) (excusing demand where all directors were either interested in the challenged transactions, lacked independence, or virtually conceded that demand was futile); *In re* Comverse Tech., Inc., Derivative Litig., 866 N.Y.S.2d 10, 16–17 (N.Y. App. Div. 2008) (citing *Ryan* with approval and excusing demand, thereby reversing lower court dismissal of shareholder derivative complaint alleging improper back-dating of options).

99. No. 5215–VCG, 2011 WL 4826104 (Del. Ch. Oct. 12, 2011).

in “highly risky trading practices and by over-leveraging the company’s assets.”[100] Anyone who has followed the 2008 financial crisis is familiar with reports of abuse in the high-pressure conference rooms and high-frequency trading stations at the “elite” investment houses. Of course, complaints must rely on fact, not innuendo. This complaint alleged staggering facts. For example, Goldman’s compensation committee adopted—or put less diplomatically—rubber stamped the proposal to link pay to revenues.[101] In 2008, “the Trading and Principal Investment segment [of Goldman] produced $9.06 billion in net revenues, but as a result of discretionary bonuses paid to employees *lost* more than $2.7 billion.”[102] Goldman’s giveaways to management contributed to the plunge of Goldman’s 2008 net income by $9.3 billion, and, if it were not for Goldman’s restructuring to a bank holding company and cash infusions from Warren Buffett and the federal government, Goldman would have collapsed into bankruptcy.[103]

These allegations raised serious issues of malfeasance. Any director with any sense of self-preservation would shudder at being named a defendant in such a lawsuit. Since the shareholders named as defendants the directors who had instituted the challenged structure, it would seem that, as a matter of course, the court ought to have excused demand on the board. It would take a rare individual to initiate a lawsuit against himself or herself. This common sense approach, however, is not the law.[104] The court will excuse demand only when the shareholders meet the above-mentioned requirements.

The *Goldman* court began its analysis by noting that the shareholders seeking excuse from demand must impugn the impartiality of a majority of directors.[105] Thus, for example, if only four of nine, or five of eleven, directors have a financial conflict of interest with the corporation—let us say, they received a bribe to approve a dubious merger—the court would not excuse demand because, presumably, the majority may be trusted to make an impartial judgment, despite the conflicting interests of the minority.[106] Such unbridled faith in the steadfastness of directors ignores the power of camaraderie and friendship, the influence of the CEO, and the toll that psychology takes on impartiality in the corporate boardroom.

Facing this unrealistic standard, the *Goldman* complaint exposed palpable conflicts of interest on the part of all the directors, but the court minimized these conflicts as if they were mere trifles.[107] For example, Goldman director Ruth Simmons

100. *Goldman*, 2011 WL 4826104, at *1.

101. *Id.* at *3.

102. *Id.* at *4 (quoting Compl. ¶ 92).

103. *Id.*

104. *See* Silver v. Allard, 16 F. Supp. 2d 966, 970–71 (N.D. Ill. 1998) (finding that the mere fact that directors were asked to sue themselves is insufficient to demonstrate lack of independence); *In re* Citigroup S’holder Derivative Litig., 964 A.2d 106, 121 (Del. Ch. 2009) (holding that plaintiff’s naming of directors as defendants is insufficient to excuse demand).

105. *Goldman*, 2011 WL 4826104, at *7–8.

106. *See, e.g.*, Weinberg *ex rel.* Biomed Realty Trust, Inc. v. Gold, 838 F. Supp. 2d 355, 360 (D. Md. 2012) (refusing to excuse demand because only two of seven directors profited personally from the compensation plan challenged in a shareholders’ derivative suit).

107. *Goldman*, 2011 WL 4826104, at *8–12 (minimizing the conflicts of interests of the directors of

was a member of Goldman's compensation committee.[108] As president of Brown University, one of her duties was fundraising, an activity on which her livelihood depended.[109] The Goldman Foundation, the charitable arm of Goldman, pledged an undisclosed sum of financial support for a project of Brown University; and, the Goldman Foundation had, by the time of the lawsuit, allocated $200,000 to this project.[110] Yet the court found allegations of this conflict of interest insufficient to raise a question as to Simmons's impartiality.[111] The court's reasoning was befuddling. The complaint, the court observed, failed to allege the "materiality" of the donation to Brown University.[112] This shortcoming of the complaint, said the court, was evident inasmuch as plaintiffs did not state the percentage of Goldman's donation compared to the total of all donations.[113] The court's observation seems incomprehensible, however, because a $200,000 donation raises the specter of a conflict of interest regardless of the size of other donations. Furthermore, one would expect that nonpublic facts of other donations would be the grist of discovery, not a requirement of notice pleading.

The court also faulted the complaint for not alleging Simmons's role in soliciting the donations.[114] Again, the court's reasoning abandoned common sense. Simmons's role in soliciting the donation was irrelevant; the relevant fact was that Goldman made the donation. It was the very existence of this sizeable donation and the promise of future donations that created an unacceptable conflict of interest. It was fanciful for the court to believe that Simmons would commence a lawsuit against other prominent players in Goldman's power structure if the cost to her and her charitable interests might have been the loss of a truckload of cash.

Finally, the court criticized the complaint for not providing specifics about how Goldman's donation affected Simmons's livelihood.[115] The court could not have seriously believed that the plaintiffs would have such intimate knowledge of Simmons's financial affairs before discovery. The plaintiffs might have ascertained such information by deposing Simmons and inspecting relevant documents, but they never had the chance. In any event, Simmons's commitment to Brown University and the conflict of interest that arises from the Goldman donations to Brown would not have vanished simply because Simmons had not profited from the donations so significantly that her livelihood would have been materially affected.

An even more flagrant example of the court's unwillingness to disqualify a director came with its discussion of the conflicts of interest attaching to Stephen Friedman, another member of Goldman's compensation committee.[116] Similar to the allegations lodged against Director Simmons, those asserted against Director Friedman

Goldman Sachs).

108. *Id.* at *10.

109. *Id.*

110. *Id.*

111. *Id.*

112. *Id.*

113. *Id.*

114. *Id.*

115. *Id.*

116. *Id.* at *11.

showed that he was a trustee of Columbia University, an institution benefiting from at least $765,000 of the Goldman Foundation's largesse.[117] Predictably, these facts did not sway the court.[118] The plaintiffs also alleged that Goldman had "invested at least $670 million in funds managed by Friedman."[119] The sheer magnitude of this investment might sound damning to an ordinary person, but not to the court, which was untroubled because the complaint did not detail how this $670 million investment affected Friedman's livelihood.[120] Such an additional allegation, the court cautiously instructed, *might* demonstrate lack of independence.[121] It would seem that the court was ready, willing, and able to put itself through the contortions of a carnival acrobat to vindicate Goldman's directors of any appearance of partiality.

2. Overcoming the Business Judgment Rule

Having found that the complaint had not adequately pleaded that the directors were enmeshed in unacceptable conflicts of interest, the *Goldman* court went on to discuss whether the complaint pleaded facts sufficient to overcome the business judgment rule. If the complaint did allege such facts, the court would excuse a demand on the board of directors.[122] The court explained that the complaint must allege with particularized facts either (1) that the directors were guilty of intentional dereliction of their duties to the corporation, or (2) that the directors acted in bad faith in failing to be adequately informed of the facts relevant to the challenged decision.[123]

In a vain attempt to satisfy the first prong—intentional dereliction—the complaint alleged that the board, year after year, had approved the payment of between 44% and 48% of Goldman's annual revenues to Goldman employees.[124] This practice, said the complaint, encouraged management to engage in excessive risk-taking.[125] Regardless of whether the stock price of Goldman rose or fell, management, as a result of this payment scheme, was overcompensated.[126] The court rejected this challenge to the loyalty of the board because the complaint, rather than alleging that the board had not used any metrics at all, had merely attacked the metrics that the board did use.[127] Because the complaint had not alleged that the board acted with conscious disregard for the welfare of Goldman, the complaint failed to rebut the business judgment rule's presumption of director good faith.[128]

The complaint fared no better in its attempt to show that the board was not adequately informed when it made the compensation decision. The complaint alleged,

117. *Id.*
118. *Id.*
119. *Id.* (quoting Compl. ¶ 160).
120. *Id.*
121. *Id.*
122. *Id.* at *12–16.
123. *Id.*
124. *Id.* at *13.
125. *Id.*
126. *Id.*
127. *Id.* at *13–14.
128. *Id.* at *14.

for example, that the directors never assessed the contributions of management to increased revenues.[129] The court found this allegation insufficient because, as was true of the allegations of intentional dereliction, it did not show that the directors had acted in bad faith.[130]

D. *Special Litigation Committees and the Business Judgment Rule*

If the court excuses demand, or if the court requires demand and the board of directors refuses to initiate litigation, the shareholders may commence a derivative suit.[131] In either situation, a board of directors may appoint an SLC to investigate the propriety of the derivative suit, and, once having found the complaint improper, the SLC may move to dismiss it.[132]

Most courts have followed one of three standards in deciding such motions.[133] The approach most favorable to the litigating shareholders is found in *Zapata Corp. v. Maldonado.*[134] In *Zapata*, the Delaware Supreme Court announced a two-step process for deciding an SLC's motion to dismiss a shareholder derivative suit.[135] First, the Chancery Court must inquire into the good faith and independence of the SLC and the reasonableness of the SLC's conclusion.[136] The burden of proof is on the SLC.[137] If the Chancery Court finds that the SLC has not met this burden of proof, the court will deny the motion.[138] If the Chancery Court finds that the SLC has met its burden of proof, the court may, in its discretion, use its own business judgment to decide the motion.[139] In exercising its discretion, the court must balance the interests of the corporation as expressed by the litigant-shareholders, with the interests of the corporation as expressed by the SLC.[140]

The second approach, which is prescribed in the Revised Model Business Corporation Act (RMBCA), provides that a court must grant an SLC's motion to dismiss a shareholder derivative suit if the SLC determines in good faith and after

129. *Id.* at *15.

130. *Id.*

131. Thomas P. Kinney, *Stockholder Derivative Suits: Demand and Futility Where the Board Fails to Stop Wrongdoers*, 78 MARQ. L. REV. 172, 175 (1994).

132. James L. Rudolph & Gustavo A. del Puerto, *The Special Litigation Committee: Origin, Development, and Adoption Under Massachusetts Law*, 83 MASS. L. REV. 47, 47–48 (1998).

133. Kenneth B. Davis, Jr., *Structural Bias, Special Litigation Committees, and the Vagaries of Director Independence*, 90 IOWA L. REV. 1305, 1306 (2005).

134. 430 A.2d 779 (Del. 1981).

135. *Zapata*, 430 A.2d at 788–89.

136. *Id.* at 788.

137. *Id.*

138. *Id.* at 789.

139. *Id.*

140. *Id.*; *see also In re* Oracle Corp. Derivative Litig., 824 A.2d 917, 943 (Del. Ch. 2003) (finding that "human nature" compromised the independence of committee members who had personal and financial entanglements with board members named in a shareholder derivative suit); Jeremy J. Kobeski, Comment, In re Oracle Corporation Derivative Litigation*: Has a New Species of Director Independence Been Uncovered?*, 29 DEL. J. CORP. L. 849, 850–51 (2004) (arguing that the *Oracle* court expanded the inquiry of director independence by considering the personal and philanthropic relationships of the members of the SLC to the directors charged with wrongdoing).

reasonable inquiry that the suit is not in the best interests of the corporation.[141] The burden of proof is on the shareholder unless a majority of the board is not independent.[142] The third approach, which is followed in New York, is most favorable to the SLC. In *Auerbach v. Bennett*,[143] the court declared that the business judgment rule applies to decisions of SLCs.[144] If committee members can show "disinterested independence," the court will grant an SLC's motion to dismiss a shareholders' derivative complaint.[145]

E. Corporate Waste and the Disguised Business Judgment Rule

Aside from claims alleging breach of fiduciary duty, shareholders often allege that directors, by approving excessive compensation packages for managers, wasted corporate assets. In the *Goldman* case, the plaintiffs alleged that Goldman employees received pay that was two to six times higher than the pay that Goldman's peers—Bear Stearns, Citigroup, Merrill Lynch, Morgan Stanley, and Bank of America—awarded to their employees.[146] Even more damning, the complaint alleged that in 2008 Goldman's Trading and Principal Investments segment produced revenues of $9.06 billion, but that discretionary bonuses resulted in a net loss of $2.7 billion.[147] These allegations would seem, at the very minimum, to have raised an issue that the board squandered corporate assets.

In ruling on the sufficiency of the corporate waste claim, the court did not expressly apply the business judgment rule, though in effect it did.[148] Squeamish to assess the reasonableness of executive compensation, it based its analysis on the strict requirements of pleading corporate waste.[149] The standard is virtually identical to that

141. MODEL BUS. CORP. ACT § 7.44(a) (2011).

142. *Id.* § 7.44(d), (e).

143. 393 N.E.2d 994 (N.Y. 1979).

144. *Auerbach*, 393 N.E.2d at 999–1000.

145. *Id.* at 1001.

146. *In re* Goldman Sachs Grp., Inc. S'holder Litig., No. 5215–VCG, 2011 WL 4826104, at *16 (Del. Ch. Oct. 12, 2011).

147. *Id.* at *17.

148. Claims of corporate waste are not ordinarily analyzed under the business judgment rule because sufficiently alleging corporate waste rebuts the presumption of the business judgment rule, but alleging and establishing corporate waste is at least as difficult as proving a breach of fiduciary duty. *See In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 749 (Del. Ch. 2005) (stating that the standard for corporate waste is the unconscionable squandering of corporate assets); Andrea M. Matwyshyn, *Imagining the Intangible*, 34 DEL. J. CORP. L. 965, 1005 (2009) (noting that Delaware courts do not generally apply the business judgment rule to corporate waste claims). The business judgment rule is applied to corporate waste claims when the board of directors did not affirmatively approve allegedly wasteful transactions. *Cf. In re* infoUSA, Inc. S'holders Litig., 953 A.2d 963, 986–87 (Del. Ch. 2007) (explaining that in a shareholder derivative suit alleging excessive executive compensation, demand on the board of directors is not excused for claims of corporate waste where the board did not affirmatively approve the challenged transactions).

149. *Goldman*, 2011 WL 4826104, at *16–18. In *Zupnick v. Goizueta*, Coca-Cola's board of directors, pursuant to a stock option plan adopted by the board and approved by the shareholders, awarded the company's CEO, Roberto C. Goizueta, options to purchase one million shares of Coca-Cola stock. 698 A.2d 384, 385 (Del. Ch. 1997). A shareholder alleged in a derivative suit that the option grant to Goizueta constituted corporate waste. *Id.* This claim rested on the charge that the board awarded the options to Goizueta for work he had already performed and for which he had already been compensated. *Id.* at 386. The complaint

under the business judgment rule, requiring bad faith on the part of the directors.[150] The court found the allegations of corporate waste too vague to support a charge of bad faith and therefore dismissed the corporate waste claim.[151]

III. ARGUMENTS SUPPORTING THE BUSINESS JUDGMENT RULE

Litigating executive compensation claims usually fails. As discussed earlier in Section II, by applying the law, judges countenance indefensible compensation packages, regardless of the magnitude of the pay, the imposition of undue influence, and even deception. Judges tolerate too much. The reason for this judicial failure is that the law is stacked against the complaining party. This Section discusses the justifications for the business judgment rule. Section IV then shows that these justifications do not apply to challenges to executive compensation, and Section V suggests that arbitration is the ideal approach to resolve such challenges because arbitrators are free to rely on their sense of justice rather than on inapt principles of law.

A. Justifications for the Business Judgment Rule

There are sensible justifications for the business judgment rule that apply in a wide range of business decisions. These justifications are discussed below.

1. Judicial Lack of Expertise in Business Matters

Perhaps the most trenchant argument supporting the business judgment rule is that judges should not interfere in the management of corporate affairs.[152] Judges may understand the law of contracts, torts, trusts and estates, and taxation; they may know when an employer has violated civil rights law and when a broker-dealer has committed unlawful insider trading. But judges are not necessarily expert in running a

alleged that the company therefore received no consideration for the option grant. *Id.* The board asserted that the option grant was a good faith exercise of its business-judgment prerogative and that Coca-Cola had, in any event, received consideration, including Goizueta's continued service as CEO of the company and the motivational effect that the grant had on other key employees who might hope to receive such corporate beneficence in the future. *Id.* The plaintiff argued in response that the board had not complied with its fiduciary duties by awarding Goizueta retroactive compensation and that the option grant could not have induced Goizueta to remain with the company because he had the right to exercise the options the very day the board awarded them. *Id.* In granting the motion to dismiss the complaint, the court noted that the standard for pleading corporate waste is extreme and rarely met. *Id.* at 387. The burden on the plaintiff, the court stated, is to allege that "no person of ordinary, sound business judgment would say that the consideration received for the options was a fair exchange for the options granted." *Id.* (quoting Michelson v. Duncan, 407 A.2d 211, 224 (Del. 1979)). Because Coca-Cola had prospered during Goizueta's tenure as CEO, the court held that the board might have found the magnitude of his past contributions sufficient to justify the bountiful option grant. *Id.* at 387–88. *But see Michelson*, 407 A.2d at 216–18 (holding plaintiffs' complaint stated a claim for waste where it alleged that the directors granted options without consideration and lacked authority to modify the company's option plan).

150. *Goldman*, 2011 WL 4826104, at *16.

151. *Id.* at *16–17.

152. *See* Joy v. North, 692 F.2d 880, 886 (2d Cir. 1982) (remarking that judges, with the aid of hindsight, should not second-guess directors who had to make decisions with imperfect information under the pressure of business conditions).

business.[153] They may have traveled from their law school classrooms to the courthouse without ever having taken a detour through the business world. Businesspeople, it follows, know more about their businesses than judges. A director who has sat on a corporate board for a substantial period of time or a high-ranking manager with substantial corporate responsibility ought to appreciate the issues confronting that corporation more than the smartest judge sitting on the highest court.

Corporate managers and directors must meet their fiduciary obligations to their corporations and shareholders, but the law must give them a wide degree of latitude in formulating policies and implementing strategies to achieve those policies.[154] Freed of judicial intrusions into corporate affairs, businesspeople may pursue policies and strategies, which, although arguably questionable at inception, may, in the long run, lead to high profits for shareholders and innovation for the benefit of society at large.[155] Vice Chancellor Glasscock made precisely this point in *Goldman* when he stated:

> Within the boundary of fiduciary duty, however, these corporate actors [officers and directors] are free to pursue corporate opportunities in any way that, in the exercise of their business judgment on behalf of the corporation, they see fit. It is this broad freedom to pursue opportunity on behalf of the corporation, in the myriad ways that may be revealed to creative human minds, that has made the corporate structure a supremely effective engine for the production of wealth.[156]

Vice Chancellor Glasscock was not shy about acknowledging the limitations of his profession. "[J]udges," he recognized, "are ill-suited by training (and should be disinclined by temperament) to secondguess the business decisions of those chosen by the stockholders to fulfill precisely that function [of corporate decision making]."[157] The court in *In re Caremark International Inc. Derivative Litigation*[158] similarly reasoned that a standard permitting more judicial oversight of business decisions "would expose directors to substantive second guessing by ill-equipped judges or juries, which would, in the long-run, be injurious to investor interests."[159]

2. The Threat to Corporate Risk-Taking

A corollary to this argument is that no branch of the government should intrude into the realm of private enterprise.[160] This corollary captures the pragmatic point that

153. *See In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 967 (Del. Ch. 1996) (observing that judges are not suited to second-guess business policy decisions).

154. *See, e.g.*, Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985) (noting that while shareholders must be protected, directors must be afforded some discretion in making important business decisions).

155. *See, e.g.*, *Joy*, 692 F.2d at 886 (observing that "[s]ome opportunities offer great profits at the risk of very substantial losses, while the alternatives offer less risk of loss but also less potential profit").

156. *In re* Goldman Sachs Grp., Inc. S'holder Litig., No. 5215–VCG, 2011 WL 4826104, at *1 (Del. Ch. Oct. 12, 2011).

157. *Id.*

158. 698 A.2d 959 (Del. Ch. 1996).

159. *Caremark*, 698 A.2d at 967.

160. One might argue that the judicial enforcement of arbitration awards under the Federal Arbitration Act (FAA) represents state action. *See, e.g.*, 9 U.S.C. § 10 (2002) (prescribing the grounds for vacating an arbitration award). The degree of state entanglement in the enforcement of privately negotiated arbitration

state intrusion may stifle justifiable risk-taking and the long-term societal benefits that may flow from adventurous entrepreneurism. For example, when Steve Jobs founded Apple, few would have predicted that an unperfected, somewhat clunky-looking box with a screen might revolutionize the processing of data. The decision to launch Apple might never have occurred if the decision had been left to government officials. The view that government should sequester itself from corporate decision making underpins other areas of law. Federal securities law provides an instructive example. Rather than following a merit system, where a governmental agency evaluates whether a business is worthy of making a public offering of securities, U.S. securities law follows a disclosure system.[161] As long as an issuer publicly discloses all material information related to an offering, the government will allow the offering to proceed.[162] Given the necessary disclosures, the public may decide whether it wishes to bear the risk of the business venture. Investors may jump into new, risky issues, or they may step back, but they, as the voice of the free market, decide.

3. State Intrusions into Private Enterprise

This anti-state-entanglement argument also raises broader concerns about capitalism and individual liberty. The champions of the private enterprise system find government intervention into business repugnant. Free enterprise means freedom from state intermeddling because state intrusions into an otherwise free market threaten not only economic freedom but also political freedom. In *McQuillen v. National Cash Register Co.*,[163] a 1939 case, the pay package for National Cash Register's new president consisted of a $100,000 annual salary plus options that rose in value to well over $1,000,000.[164] Shareholders alleged that this sum, exorbitant by 1939 standards, constituted corporate waste.[165] Dismissing the claim, Judge Coleman explained:

> Excessive compensation results from poor judgment, not *necessarily* from anything else. If the rule [courts deferring to boards of directors in cases challenging excessive compensation] were otherwise, the result would be destruction of autonomy in private enterprise to a degree that would render such enterprise no longer private; personal initiative and its just rewards would disappear, and this would undermine the very basis upon which our

agreements, however, is not sufficiently significant to invoke the state-action doctrine. *See* Sarah Rudolph Cole, *Arbitration and State Action*, 2005 BYU L. REV. 1, 16 (2005) (concluding that federal enforcement of arbitration awards does not constitute state action).

161. Insisting on a disclosure model for federal securities law, President Franklin Roosevelt stated: "There is . . . an obligation upon us to insist that every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public." H.R. REP. NO. 73-85, at 2 (1933).

162. 15 U.S.C. § 77aa (2012); *see also* Basic, Inc. v. Levinson, 485 U.S. 224, 234 (1988) (stating that "[d]isclosure, and not paternalistic withholding of accurate information, is the policy chosen and expressed by Congress"); Omari Scott Simmons, *Taking the Blue Pill: The Imponderable Impact of Executive Compensation Reform*, 62 SMU L. REV. 299, 328 (2009) (commenting that the federal law of securities regulation relies on a disclosure system).

163. 27 F. Supp. 639 (D. Md. 1939).

164. *McQuillen*, 27 F. Supp. at 652–54; Harwell Wells, *"No Man Can Be Worth $1,000,000 a Year": The Fight over Executive Compensation in 1930s America*, 44 U. RICH. L. REV. 689, 731 (2010).

165. *Id.*

> economic life, with its constitutional guaranties, is founded, and upon which our democratic form of government depends.[166]

Milton Friedman argued similarly that capitalism is a necessary precondition for a free society.[167] It is apparent that a free market economy results in economic freedom in that market participants may engage in whatever exchanges they desire.[168] But a free market economy also promotes political freedom.[169] Friedman observed that political freedom is the absence of coercion.[170] The fundamental threat to political freedom, Friedman argued, is the concentration of power, particularly in the government.[171] Although government serves an indispensable role in establishing the rules for market participants, the involvement of government in business affairs should be kept to the minimum necessary to ensure a smoothly functioning market system free of coercion.[172] Friedman suggested that a free market economy achieves this end by transferring power from the government to individual market participants.[173] State imposed limitations on a free market economy strengthen the state's position to restrict political freedom.[174] Friedman therefore concluded that a strong business community is a bulwark against state economic and political coercion.[175]

B. The Salutary Application of the Business Judgment Rule

Though the business judgment rule is poorly suited for executive compensation controversies, courts apply it sensibly in a wide range of business decisions. One recurrent situation in which the courts apply the business judgment rule is when shareholders challenge the response of the board of directors to merger proposals.[176]

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166. *Id.* at 653; *see also* Wells, *supra* note 164, at 726–32 (pointing out that in the 1930s courts ruling on challenges to excessive executive compensation moved from a reasonableness standard to a bad faith or total neglect standard).

167. According to Milton Friedman:

> Economic arrangements play a dual role in the promotion of a free society. On the one hand, freedom in economic arrangements is itself a component of freedom broadly understood, so economic freedom is an end in itself. In the second place, economic freedom is also an indispensable means toward the achievement of political freedom.

MILTON FRIEDMAN, CAPITALISM AND FREEDOM: FORTIETH ANNIVERSARY EDITION 8 (2002).

168. *Id.* at 15.

169. *Id.*

170. *Id.*

171. *Id.*

172. *Id.* Friedman argued: "The existence of a free market does not of course eliminate the need for government. On the contrary, government is essential both as a forum for determining the 'rules of the game' and as an umpire to interpret and enforce the rules decided on." *Id.* Friedman's views reserve a role for courts in resolving business disputes, but that role should be kept to a minimum. *Id.* The proposal in this Article achieves Friedman's objectives by removing compensation cases from the courtroom to an arbitral forum.

173. *Id.*

174. *Id.*

175. Friedman believed that market forces subdue governmental encroachment into political freedoms. He observed: "By removing the organization of economic activity from the control of political authority, the market eliminates this source of coercive power. It enables economic strength to be a check to political power rather than a reinforcement." *Id.*

176. *E.g.*, Lyondell Chem. Co. v. Ryan, 970 A.2d 235 (Del. 2009); Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361 (Del. 1995); Revlon, Inc. v. MacAndrews & Forbes Holding, Inc., 506 A.2d 173 (Del. 1986);

The courts, however, apply an attenuated version of the business judgment rule to mergers. The reason for this downward adjustment is that "when a board implements anti-takeover measures there arises 'the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders[].'"[177] Thus, in merger cases, the burden shifts to the directors to prove that the proposed merger posed a danger to corporate policy and effectiveness; the directors must prove their good faith, reasonable investigation, and the reasonableness of the defensive measures taken in relation to the threat the merger posed to the company.[178]

In *Lyondell Chemical Co. v. Ryan*,[179] the Delaware Supreme Court exonerated directors charged with wrongfully approving a merger.[180] Lyondell "was the third largest independent, publicly traded chemical company in North America."[181] Basell AF was a privately held Luxembourg company in the business of developing and marketing chemical products.[182] Basell expressed an interest in acquiring Lyondell, initially offering $26.50 per share.[183] Ultimately, after negotiations with Lyondell, Basell raised its offer to $48 per share.[184] The Lyondell board approved the transaction, as did a majority of the shareholders.[185]

In a class action lawsuit, disgruntled shareholders accused the directors of breaching their fiduciary duties of care and loyalty.[186] Among numerous charges of wrongdoing, the shareholders alleged that the merger price was "grossly insufficient."[187] The directors moved for summary judgment, but the Chancery Court denied the motion because Lyondell's directors had neither seriously pressed Basell for a higher price nor conducted even a limited market check to verify that the merger offer was optimal.[188] Such "unexplained inaction," the court believed, permitted a reasonable inference that the directors consciously disregarded their fiduciary duties.[189] The

Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985).

177. *Revlon*, 506 A.2d at 180 (quoting *Unocal*, 493 A.2d at 954).

178. *Id.*

179. 970 A.2d 235 (Del. 2009).

180. *Lyondell*, 970 A.2d at 243–44. Although the court did not refer explicitly to the business judgment rule, its analysis of the fiduciary duties of the directors followed the analysis appropriate under the business judgment rule. *Id.*

181. *Id.* at 237.

182. *Id.*

183. *Id.*

184. *Id.* at 238.

185. *Id.* at 239.

186. *Id.*

187. *Id.* The complaint also alleged that (1) the directors approved the transaction out of self-interest rather than the interests of the company and its shareholders, (2) the merger negotiation process was flawed, (3) the directors agreed to unreasonable deal protection provisions, and (4) the preliminary proxy statement omitted material facts. *Id.*

188. *Id.* at 241. The Chancery Court also criticized the board for taking no action to prepare for a possible acquisition proposal after an Access affiliate filed a Schedule 13D with the Securities Exchange Commission in which it disclosed its intention to acquire 8.3% of Lyondell stock. *Id.* at 237, 241–42. The filing also disclosed Basell's interest in acquiring Lyondell. *Id.*

189. *Id.* at 237, 243 (quoting Ryan v. Lyondell Chem. Co., No. 3176-VCN, 2008 WL 4174038, at *4

Delaware Supreme Court reversed the lower court's ruling and granted the motion for summary judgment.[190] Noting that under the conscious disregard standard "[d]irectors' decisions must be reasonable, not perfect," the court found that the directors had not consciously disregarded their fiduciary duties to the shareholders and the corporation.[191] The record showed that the directors (1) met several times to consider Basell's offer, (2) were generally aware of the value of Lyondell, (3) solicited and followed the advice of their financial and legal advisors, and (4) attempted to negotiate a higher price.[192] Thus, the court concluded that, even assuming that the board did nothing to prepare for Basell's offer, and assuming further that the board did not so much as consider conducting a market check, the directors could not reasonably be accused of conscious disregard of their duty of loyalty to Lyondell.[193] Taking a "wait and see" strategy "was an entirely appropriate exercise of the directors' business judgment."[194]

IV. Why the Business Judgment Rule Should Not Apply to Cases Challenging Executive Compensation

Challenges to excessive executive compensation are unique in several respects compared to other types of breach of fiduciary claims brought against officers and directors. This Section of the Article shows that the reasons for applying the business judgment rule to many corporate decisions do not apply to executive compensation decisions.

A. Director Corruption, Bias, and Inattentiveness

The *Lyondell* case represents a valid use of an attenuated version of the business judgment rule. As the Delaware Supreme Court stated, shareholders cannot reasonably expect perfection from decisions of directors.[195] Such a strict standard would expose directors to endless liability from a countless number of lawsuits spawned by a numberless cadre of litigious shareholders. If the law encouraged such lawsuits, directors might focus more on legal matters than on corporate affairs. Potential directors, though competent and otherwise willing to serve, might balk at sitting on corporate boards, fearing interminable deposition sessions and recurrent courtroom appearances. Nevertheless, as *Lyondell* instructs, because merger situations create the threat of director self-dealing at the expense of the company and its shareholders, the burden of proof shifts to the directors to show their reasonableness and good faith.[196]

Shareholder challenges to excessive executive compensation present an even greater threat of director partiality and corruption than do merger cases. The threat is so

(Del. Ch. Aug. 29, 2008)).

190. *Id.* at 244.

191. *Id.* at 243–44.

192. *Id.* at 244.

193. *Id.* at 243–44.

194. *Id.* at 242.

195. *Id.* at 243.

196. Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 180 (Del. 1985).

pervasive in executive compensation cases that, rather than applying an attenuated version of the business judgment rule, courts should not apply the rule at all.

Professors Lucian Bebchuk and Jesse Fried have argued in their seminal book, *Pay Without Performance*, that CEOs wield enormous influence over directors.[197] This influence inflates CEO pay to levels that delink it from performance.[198] Being elected to a corporate board is like receiving a Christmas gift. In addition to an ego-boosting measure of prestige, lucrative business contacts, and assorted perks, such positions carry substantial salaries—sometimes upwards of $100,000 annually—for a minimal amount of work.[199] CEOs tend to have sway over the process of nominating candidates for the boards of their companies.[200] It is therefore not surprising that directors often approve whatever self-indulgent compensation package powerful CEOs propose.[201] This problem degenerates into a system of quid pro quo, since it is commonplace for CEOs of two different companies to sit on one another's boards.[202] Pay inevitably spirals upward.

Subtle social forces are also at work. Directors want to fit in; they want their colleagues to see them as team players, not obstructionists.[203] Bucking a majority of the board of directors and the will of the CEO requires an unusually resolute personality.[204] Independent directors, with limited knowledge of corporate affairs, may feel unqualified to oppose the salary demands of a powerful CEO, who, like Jamie Dimon of J.P. Morgan, or Steve Jobs, the iconic head of Apple until his untimely death in 2012, may be viewed as near Messianic figures.[205] Because independent directors have careers apart from their part-time positions as directors, they may defer to the judgment of compensation consultants hired by the corporation.[206] Unfortunately, CEOs exert

197. *See* LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 26–27 (2004) (explaining that directors may feel compelled to approve excessive CEO compensation packages because CEOs are typically on committees that nominate candidates for the board of directors).

198. *See id.* at 63 (arguing that when pay is decoupled from performance, managers may be inclined to abandon their commitment to the corporation they ostensibly serve).

199. *Id.* at 25; *see also* Gary Strauss, *Companies Pony Up to Keep Directors*, USA TODAY, Nov. 21, 2002, at B1 (reporting that the average compensation in 2002 for outside directors sitting on the boards of Fortune 1,000 companies was $116,000 and that the number jumped to a hefty $152,000 for the top 200 publicly traded companies). Since Strauss's reporting in 2002, director compensation has ballooned. *See* Gary Strauss, *Compensation for Corporate Directors Rises Sharply*, USA TODAY, Mar. 4, 2011, at A1 (reporting that, in 2009, the largest 200 publicly traded companies paid their directors a startling median salary of $228,000, that Occidental Petroleum's directors averaged nearly $420,000, and that Apple's directors averaged more than $984,000 in 2010).

200. *See* BEBCHUK & FRIED, *supra* note 197, at 26 (noting that CEOs are often on the nominating committee, and, even if they are not, they may exert a strong influence on the nominating process, thereby benefiting friends and punishing opponents).

201. *See* Michael B. Dorff, *Does One Hand Wash the Other? Testing the Managerial Power and Optimal Contracting Theories of Executive Compensation*, 30 J. CORP. L. 255, 277 (2005) (finding experimentally that powerful CEOs extract higher pay agreements than less powerful CEOs).

202. BEBCHUK & FRIED, *supra* note 197, at 29–30.

203. *Id.* at 32.

204. *Id.* at 31–33.

205. *Id.* at 36–37.

206. *Id.* at 37.

influence over the selection and retention of the very consultants who must evaluate compensation proposals.[207]

Despite the fiduciary duties of care, loyalty, and good faith that the law imposes, directors are subject to the human frailties of greed and self-interest that affect us all.[208] As directors, they are required to protect the interests of the corporation, but corporate money is not *their* money. Vigilance wanes when other people's wealth, rather than one's own wealth, is at risk.[209] Adam Smith once famously observed: "The directors of [a joint stock company], however, being the managers rather of other people's money than of their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own."[210]

Although Bebchuk and Fried lament the decoupling of pay from performance, the problem of excessive compensation cannot be solved merely by linking the two.[211] As the *Disney* case, the *Grasso* case, the *Goldman* case, and innumerable instances of exorbitant compensation arrangements demonstrate, the core of the problem is the sheer magnitude of many compensation packages. Imagine a corporate compensation scheme that calibrates compensation in perfect congruence with CEO performance: the greater the CEO's contribution to corporate profits, the greater his or her compensation. The CEO's compensation might take the form of salary, bonuses, options, restricted stock, or stock appreciation rights. The plan might defer the vesting of rights to discourage imprudent risk-taking and to align the interests of the CEO with those of the company. Imagine that this ideally structured compensation methodology awards a satisfactorily performing CEO 50% of corporate profits or revenues, an excellently performing CEO 75% of corporate profits or revenues, and a superbly performing CEO 100% of corporate profits or revenues. This model plan matches pay to performance with mathematical precision. The correlation coefficient between pay and performance is a rousing 1.0.[212] Yet, should the CEO excel, the plan ironically would bankrupt the

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207. *See id.* at 37–38 (noting that since compensation consultants are paid regardless of whether they optimize shareholder value, such consultants have no incentive to contradict the wishes of a CEO).

208. *Guth v. Loft*, 5 A.2d 503 (Del. 1939), is an early case discussing the fiduciary duties of corporate officers and directors. Expressing a cynical but accurate viewpoint on human nature, the court stated:

> Corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests. While technically not trustees, they stand in a fiduciary relation to the corporation and its stockholders. A public policy, existing through the years, and *derived from a profound knowledge of human characteristics and motives*, has established a rule that demands of a corporate officer or director, peremptorily and inexorably, the most scrupulous observance of his duty . . . .

Id. at 510 (emphasis added).

209. *See* Cohen v. Beneficial Indus. Loan Corp., 337 U.S. 541, 547 (1949) (lamenting that directors may become lax in monitoring the greed of managers).

210. ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 129–30 (Edwin Cannan ed., Univ. of Chicago Press 1976) (1904).

211. *See* BEBCHUK & FRIED, *supra* note 197, at 8 (defending any level of executive pay, even if higher than current levels, as long as the compensation is linked to performance).

212. *See* Bruce Ratner, *The Correlation Coefficient: Definition*, DM STAT-1 (2007), http://www.dmstat1.com/res/TheCorrelationCoefficientDefined.html (explaining that a correlation coefficient of +1 reflects a "perfect positive linear relationship").

company.

The problem of executive compensation is vexing because no one can pinpoint what is fair. One might argue that the free market should decide the issue, but as Bebchuk and Fried and numerous lawsuits have shown, the corporate boardroom, caught in the shade of cronyism, social pressures, and undue influence, is a shadowy reflection of free market capitalism.[213] Benchmarking provides no solution.[214] To base compensation on the bloated pay scale of comparable companies is to perpetuate their malfeasance. This long-accepted practice results in a boomerang effect where competitors in an industry strive to outdistance each other in an exhausting race to pay their vaunted CEOs more than their peer groups pay.[215] Regrettably, it is shareholder value that gets exhausted.

Valuing the contributions of executives and determining their fair compensation are subjective judgments. No magic caliper provides the answer. Unfortunately, the system as currently constructed often provides the wrong answer. Although determining the boundaries of appropriate executive pay may be elusive, the abuses of excessive executive pay are not only intuitive, but they are also quantitatively demonstrable. Neither undue influence, nor social pressure, nor comparisons to companies that have succumbed to those very forces should influence compensation packages. A man fired for cause should not be gifted with $130 million.[216]

This is not to say that judges or anyone else should meddle in reasonable compensation decisions. The point is simply that the law should not defer blindly to unreasonably excessive compensation agreements. Some level of oversight is appropriate because such employment decisions differ qualitatively from decisions surrounding, for example, mergers, acquisitions, product development, and market saturation.

Despite the plundering of corporations, the law does not provide an adequate remedy to rectify excessive compensation arrangements. Nor does it provide a remedy for grossly excessive compensation or even grotesquely excessive compensation. The greedy may feast heartily.

B. The Complexity of the Business Decision

One rationale for the business judgment rule is that judges may lack the expertise to evaluate complex business decisions.[217] Accordingly, some scholars argue that

213. *See* BEBCHUK & FRIED, *supra* note 197, at 53–58 (noting that while the market should constrain excessive executive compensation, market pressure has proven ineffective).

214. *See* Charles M. Elson & Craig K. Ferrere, *Executive Superstars, Peer Groups, and Overcompensation: Cause, Effect, and Solution*, 38 J. CORP. L. 487, 494–500 (2013) (discussing benchmarking, the process of considering the pay scales of competitors when constructing compensation packages, and rejecting this process as an effective deterrent to excessive executive pay).

215. *See* Jeffrey N. Gordon, *Executive Compensation: If There's a Problem, What's the Remedy? The Case for "Compensation Discussion and Analysis"*, 30 J. CORP. L. 675, 697–98 (2005) (recognizing that CEOs may use benchmarking disclosures as leverage to argue for pay raises).

216. See *supra* note 65 and accompanying text for a description of the no-fault termination clause that required Disney to pay $130 million to Michael Ovitz.

217. See *supra* Part III.A for a discussion of the rationales underlying the business judgment rule.

judges lack the expertise to decide questions of executive compensation.[218] Such questions, these scholars believe, are better left to businesspeople.[219] Others have argued to the contrary that judges are as qualified to decide executive compensation cases as any other type of case.[220] Most judges and jurors, for example, are not physicians, and yet they commonly decide, with the aid of expert testimony, whether a patient's injury resulted from a doctor's malpractice.[221] Similarly, statistical evidence offered in a discrimination suit to show that an employment practice had a disparate impact on a protected class may fall beyond the expertise of a judge. The same would undoubtedly be true of complex quantitative evidence admitted at trial or on a motion for summary judgment to prove that a defendant, charged with antitrust violations, engaged in an unreasonable restraint of trade. Judges, for the most part, do not have formal training to decide any of the factual issues presented in such cases. Nor do juries for that matter. The litigation process addresses this deficiency with expert testimony. Both parties may call expert witnesses to advance whatever point of view they propound. A judge or jury must then weigh the value of the expert testimony in reaching a decision. Challenges to excessive executive compensation should not confound judges more than claims alleging malpractice, discrimination, or antitrust violations.

Even if judges are, as a general matter, unqualified to rule on complex business issues, they are nevertheless qualified to decide challenges to executive compensation. Decisions about executive compensation do not concern highly complex matters of corporate policy or strategy such as what products or services to offer to the public, what research and development to conduct, what markets to enter, or whether to change the corporation's form by way of merger or acquisition.[222] For example, Ford might

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218. *See, e.g.*, *In re* infoUSA, Inc., S'holders Litig., 953 A.2d 963, 983–84 (Del. Ch. 2007) (listing the considerations that bear on a compensation decision and expressing a judge's aversion to having to make such a decision); Thomas C. Pelto, Sr., Note, *False Halo: The Business Judgment Rule in Corporate Control Tests*, 66 TEX. L. REV. 843, 866 (1988) (noting that one justification for the business judgment rule is that judges are not equipped to make business decisions). But see *infra* notes 222–26 and accompanying text for an argument that judges are capable of making compensation decisions because these decisions do not require the expertise needed to make more complex business judgments.

219. *See* Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 119–20 (2004) (noting that directors are likely to have more business expertise than judges but arguing that the limited business acumen of many judges does not fully justify the business judgment rule).

220. *See* Franklin A. Gevurtz, *The Business Judgment Rule: Meaningless Verbiage or Misguided Notion?*, 67 S. CAL. L. REV. 287, 307 (1994) (arguing that judges decide a variety of negligence cases that are similar in kind to business cases in which shareholders charge managers or directors with negligent decision making).

221. *See* Robert T. Miller, *Wrongful Omissions by Corporate Directors:* Stone v. Ritter *and Adapting the Process Model of the Delaware Business Judgment Rule*, 10 U. PA. J. BUS. & EMP. L. 911, 926 (2008) (arguing that courts determine negligence in professional malpractice cases with the assistance of expert testimony).

222. Professor Telman challenges the proposition that the purpose of the business judgment rule is to protect directors. D.A. Jeremy Telman, *The Business Judgment Rule, Disclosure, and Executive Compensation*, 81 TUL. L. REV. 829, 863–64 (2007). Characterizing the business judgment rule as an abstention doctrine, he posits that one purpose of the rule is to prevent disclosure of corporate confidential information, such as merger and acquisition plans and, in some instances, dividend policy. *Id.* at 866–67. Professor Telman argues that compensation decisions do not involve confidential information. *Id.* at 872. He

consider developing and marketing a new solar-powered automobile. Ford's decision would involve projecting the costs of developing and marketing the vehicle, the potential sales of the vehicle in domestic and foreign markets, the competition posed by both traditional vehicles sold by other companies and innovative vehicles under development at other companies, and innumerable other considerations. Judges should not interfere with such complex business judgments requiring the expertise of seasoned business executives who must weigh an enormous amount of imperfect data and intangibles when making such decisions.[223]

Though the decision of how much to pay an executive is important to the corporation, it is ordinarily based on fairly straightforward considerations: the experience and past performance of the executive and the competitive environment for his or her services. In rare instances companies may face more involved situations where, because of challenging business environments, they may consider hiring or retaining a CEO because of his or her plans to lead the company in a radically new direction, but CEOs do not generally announce dramatic strategic changes when negotiating compensation packages.

In *In re infoUSA, Inc. Shareholders Litigation*,[224] Chancellor Chandler questioned whether courts should decide what constitutes excessive compensation. He mused:

> "How much is too much?" The answer to that question depends greatly upon context. The acumen of the business executive, the competitive environment in the industry, and the recruitment and retention challenges faced by the hiring corporation all bear heavily on an appropriate level of compensation. "How much is too much?" is a question far better suited to the boardroom than the courtroom.[225]

Despite Chancellor Chandler's modesty, compensation issues do not lay beyond the expertise or sensibilities of judges. The relevant information, as outlined by Chancellor Chandler, is not as technical or voluminous as information bearing on more complex business policy or strategic decisions, which may involve finance, marketing, management, and accounting issues. As noted, assessing a CEO's acumen and ascertaining the competitive environment for hiring or retaining a CEO are not matters of enormous complexity similar to those that Ford would encounter if contemplating the launch of a new vehicle. Compensation committees rely on the advice of compensation consultants.[226] Given equivalent expert testimony provided in the

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therefore concludes that the business judgment rule should not apply to compensation decisions. *Id.* at 869–72. Professor Stephen Bainbridge disagrees with Professor Telman. He believes that the business judgment rule serves to limit the inefficiencies that judicial intervention would impose on corporate decision making. Bainbridge, *supra* note 219, at 84. Like Professor Telman, however, Professor Bainbridge views the business judgment rule as an abstention doctrine. *Id.* at 87. By framing the business judgment rule as an abstention doctrine, Professor Bainbridge believes that "judicial review is more likely to be the exception rather than the rule," because, rather than engaging in the elusive exercise of assessing levels of negligence, the courts would look for more concrete indicators of wrongdoing such as self-dealing, fraud, and illegality. *Id.* at 128.

223. *See* Joy v. North, 692 F.2d 880, 886 (2d Cir. 1982) (noting that, when making business judgments, managers often rely on imperfect information that is difficult to reconstruct after the fact).

224. 953 A.2d 963 (Del. Ch. 2007).

225. *InfoUSA*, 953 A.2d at 983.

226. *See* William Alan Nelson II, *Ending the Silence: Shareholder Derivative Suits and Amending the Dodd-Frank Act so "Say on Pay" Votes May Be Heard in the Boardroom,* 20 U. MIAMI BUS. L. REV. 149, 178

courtroom, a judge is as qualified as a member of a compensation committee to render an opinion on compensation.

Executive compensation cases do not raise the problem of judges second-guessing business decisions after the fact. An executive compensation arrangement is either reasonable or unreasonable at the time it is made. Post hoc complaints or justifications based on subsequent performance are irrelevant. Non-compensation-related business policy and strategic decisions are different in kind from compensation decisions. The difference is that a judge asked to evaluate noncompensation strategic and policy decisions after the fact must engage in the daunting task of weighing risk and reward factors that the decision-making manager had at his disposal when making the decision.

C. Risk-Taking Disincentives Versus the Risk of Losing Managers

A principal purpose of the business judgment rule is to prevent judges from holding business managers liable for good-faith decisions resulting in failure because such judicial second-guessing of business decisions would discourage business managers from taking calculated risks.[227] This rationale does not apply to compensation decisions. Hiring or retaining a CEO may entail risk to the corporation, but executive compensation contracts are not generally based on a risk-reward analysis. Managers are paid based on their past performance and expected future performance. Performance is measured by profits generated for the company. Directors may base their decision on the experience, reputation, or performance of the CEO.[228] They may base their decision by benchmarking what similar companies pay their CEOs.[229] They may base their decision on whether other companies are courting the same person to be their CEO.[230] The operative criteria for the decision on how much to pay a CEO, however, do not include the risks the company would encounter as a result of the CEO's leadership. Similarly, when shareholders commence derivative lawsuits challenging executive compensation, they do not challenge the quantum of risk that their company assumed as a result of a compensation agreement. Their quarrel is not that the company improvidently hired or retained a CEO. Their objection is that the company agreed to pay the CEO too much.

By abandoning the business judgment rule in cases challenging excessive executive compensation, judges would not discourage corporate risk-taking. Such challenges, however, may pose a different risk to a corporation: in response to a judicial ruling resulting in reduced pay, a manager might decline an offer of employment or end his or her affiliation with the company. This possibility arises because a judge would not be susceptible to the intimidation, social pressure, and

(2012) (stating that companies have a common practice of relying on compensation consultants when determining executive compensation).

227. See *supra* Part III.A.2 for an explanation of this rationale for the business judgment rule.

228. T. Leigh Anenson & Donald O. Mayer, *"Clean Hands" and the CEO: Equity as an Antidote for Excessive Compensation*, 12 U. PA. J. BUS. L. 947, 999 (2010) (listing various factors that may influence CEO pay).

229. *See id.* at 998–99 (calling benchmarking a "controversial practice").

230. *See id.* at 999 (citing the "need for retention in a tight labor market" as one factor that may be considered when determining executive pay).

temptations that influence directors who approve outrageous compensation agreements.[231] To equate corporate risk-taking with the risk of losing managers, however, is to conflate two very different issues.

Even if judges abandoned the business judgment rule and refused to condone excessive pay, the harm to a company would likely be minimal. Many scholars believe that the departure of a CEO poses only a minor risk to a company because the view of CEO indispensability is a corporate myth.[232] Empirical evidence supports this view, showing that when internal candidates replace departing CEOs, corporate performance remains stable.[233]

If a judge were to reduce the annual pay of a CEO from, say, $50 million to a mere $25 million, one might question whether a rational CEO would flee the company. The tendency of CEOs to accept lower pay would, moreover, increase over time because a growing body of such judicial decisions would introduce a measure of reasonableness into the accepted scale of executive pay. Lacking any alternatives, CEOs would lower their expectations and demands. Regardless of where they went, they would face shareholder derivative suits and the discretion of judges immune to the influences prevalent in the boardroom. Directors, in this climate, might become more responsible in discharging their fiduciary duties, and executive compensation agreements might therefore moderate. Fewer cases would need judicial intervention.

V. WHY ARBITRATORS SHOULD DECIDE CLAIMS CHALLENGING EXCESSIVE EXECUTIVE COMPENSATION

A. Efficiency

Litigation wastes time and money. It is a slothful system of judicial dispute resolution, which may consume years and a treasure trove of cash before a case works its way to final decision.[234] Arbitration, by contrast, is a contractual means of alternative dispute resolution, where parties submit their dispute to a nonjudicial

231. See *supra* notes 197–210 and accompanying text for a brief discussion of factors that may influence directors into succumbing to managerial power.

232. Although high-quality managers may contribute to the performance of the companies they serve, the belief that CEOs are irreplaceable is a myth. *See, e.g.*, RAKESH KHURANA, SEARCHING FOR A CORPORATE SAVIOR: THE IRRATIONAL QUEST FOR CHARISMATIC CEOS 190 (2002) (highlighting the "lack of a convincing link between CEOs and corporate performance"); Davis, *supra* note 19, at 494 n.418 (explaining that, because large corporations employ scores of talented and energetic managers, all of whom compete for promotions, there is always a pool of qualified replacements ready to assume the title of CEO).

233. *See* Wei Shen & Albert A. Cannella, Jr., *Revisiting the Performance Consequences of CEO Succession: The Impacts of Successor Type, Postsuccession Senior Executive Turnover, and Departing CEO Tenure*, 45 ACAD. MGMT. J. 717, 728–29 (2002) (finding that company performance remains stable when internal candidates replace CEOs, but performance falters, at least in the short run, when external candidates replace CEOs).

234. *See* Kenneth R. Davis, *A Model for Arbitration Law: Autonomy, Cooperation and Curtailment of State Power*, 26 FORDHAM URB. L.J. 167, 167–68 (1999) (discussing the wastefulness of litigation); Jethro K. Lieberman & James F. Henry, *Lessons from the Alternative Dispute Resolution Movement,* 53 U. CHI. L. REV. 424, 427 (1986) (pointing out that litigation is often delayed because of a "failure to communicate" stemming from a lack of trust between the adversarial parties).

decisionmaker for binding determination.[235] Because it is contractual, arbitration, rather than an inflexible litigation-like process, is pliable and efficient, enabling the parties to tailor the process to serve their needs.[236]

Both state and federal rules prescribe procedures that impede the litigation process.[237] Although pleading standards are not nearly as draconian as they were in the past, a complaint, under federal and state court rules, must still comply with certain formalities such as alleging the facts underlying the claims.[238] The answer to a complaint must admit or deny the factual allegations in the complaint and state affirmative defenses, counterclaims, and crossclaims.[239] Rather than answering the complaint, the defendant may elect to move to dismiss the complaint on any of a number of designated grounds, and should the court deny the motion, the defendant would then answer.[240]

Once the defendant has answered the complaint, discovery rules permit both parties to demand answers to interrogatories, documents, and depositions.[241] Inevitable conflict over the scope of these demands leads to motions to compel and interlocutory appeals contesting the results of those motions.[242] Armed with deposition transcripts,

235. *See* LARRY E. EDMONSON, DOMKE ON COMMERCIAL ARBITRATION § 1.1 (3d ed. 2009) ("Arbitration is a process by which parties voluntarily refer their disputes to an impartial third person (an arbitrator) selected by them for a decision based on the evidence and arguments to be presented before the arbitration tribunal."); Kenneth R. Davis, *When Ignorance of the Law Is No Excuse: Judicial Review of Arbitration Awards*, 45 BUFF. L. REV. 49, 55 (1997) (defining commercial arbitration as a contractual form of dispute resolution empowering nonjudicial decisionmakers to render binding determinations); Norman S. Poser, *Making Securities Arbitration Work*, 50 SMU L. REV. 277, 287–89 (1996) (outlining the attributes of securities arbitration and comparing them to the attributes of litigation); Stephen J. Ware, *Default Rules from Mandatory Rules: Privatizing Law Through Arbitration,* 83 MINN. L. REV. 703, 707–08 (1999) (observing that arbitration is a form of adjudication where the decisionmaker is acting in a private capacity—not as an agent of government).

236. *See* Edward Brunet, *Toward Changing Models of Securities Arbitration*, 62 BROOK. L. REV. 1459, 1463–64 (1996) (characterizing arbitration as a "creature of contract" and noting that the parties can tailor their arbitration agreement to achieve simplicity or to secure rights ordinarily associated with litigation).

237. *See* ROBIN C. LARNER, 3 CYCLOPEDIA OF FEDERAL PROCEDURE 8:13 (2013) (explaining that the Supreme Court prescribes rules of procedure and defining procedure as the "judicial process" for enforcing substantive rights).

238. *See, e.g.*, FED. R. CIV. P. 8(a)(2) (providing that a pleading alleging a claim shall contain "a short and plain statement of the claim"); N.Y. C.P.L.R. 3013 (McKinney 2013) (requiring a pleading to provide notice of the "transactions, occurrences, or series of transactions or occurrences" intended to be proven).

239. *See, e.g.*, FED. R. CIV. P. 8(b) (prescribing the pleading requirements for the answer to a complaint); N.Y. C.P.L.R. 3011 (prescribing general pleading requirements).

240. *E.g.*, FED. R. CIV. P. 12(b); N.Y. C.P.L.R. 3211.

241. *E.g.*, FED. R. CIV. P. 26; N.Y. C.P.L.R. 3101.

242. *See* Kenneth R. Feinberg, *Reexamining the Arguments in Owen M. Fiss*, *Against Settlement*, 78 FORDHAM L. REV. 1171, 1172 (2009) (criticizing litigation because of "the costs, the inefficiencies, the uncertainties, the frustrations, [and] the delays"); Arthur R. Miller, *The Adversary System: Dinosaur or Phoenix*, 69 MINN. L. REV. 1, 9 (1984) (faulting lawyers for misusing discovery as a means of delaying lawsuits); Bedora A. Sheronick, Comment, *Rock, Scissors, Paper: The Federal Rule 26(a)(1) "Gamble" in Iowa*, 80 IOWA L. REV. 363, 374 (1995) (reporting that a substantial number of attorneys complained that discovery spawned inefficiency, delay, and cost); Maurice E. Stucke, *Does the Rule of Reason Violate the Rule of Law?*, 42 U.C. DAVIS L. REV. 1375, 1384 (2009) (commenting that discovery in antitrust cases is costly and time consuming). *But see* Linda S. Mullenix, *Discovery in Disarray: The Pervasive Myth of Pervasive Discovery Abuse and the Consequences for Unfounded Rulemaking*, 46 STAN. L. REV. 1393, 1432 (1994)

documents, and affidavits, one or more of the parties may move for summary judgment, seeking to short-circuit the process on the ground that a claim does not present a triable issue of fact.[243] If the court rules against a moving party, the case proceeds to trial where judges restrict the admissibility of testimony and submissions based on the rules of evidence.[244] Once a judge or jury declares a victor, the losing party may appeal to a higher court to review the lower court decision.[245]

An aggressive lawyer may delay the final resolution of a case for years. Along with the expenditure of time comes the expenditure of a great deal of money in attorneys' fees. By delaying the ultimate outcome for so long, the litigation system burdens the litigants with uncertainty and the sense that justice is an unobtainable abstraction.

Arbitration, on the other hand, dispenses with many procedural rights and requirements that inhere in the litigation system. As noted, arbitration is a matter of contract, and as such the parties to an arbitration agreement may structure the arbitration process to suit their needs.[246] Frequently, disputing parties believe that many of the procedural complexities of litigation are more detrimental than beneficial and clutter an otherwise fair process with nonessential roadblocks.[247] Although the arbitration process must provide the parties with a fundamentally fair hearing,[248] the parties, for the sake of efficiency, frequently choose in their agreement to relinquish many litigation procedures.[249] It is commonplace for them to forego pleading

(arguing that, based on empirical data, discovery abuse is a myth); David M. Trubek et al., *The Costs of Ordinary Litigation*, 31 UCLA L. REV. 72, 89 (1983) (questioning whether discovery is often abused).

243. *E.g.*, FED. R. CIV. P. 56; N.Y. C.P.L.R. 3212.

244. *See* FED. R. EVID. 103 (prescribing framework for judicial evidentiary rulings).

245. *See, e.g.*, CHARLES ALAN WRIGHT & ARTHUR R. MILLER, FEDERAL PRACTICE AND PROCEDURE § 2588 (2d ed. 1995) (noting that in the federal system circuit courts review district court decisions for errors of law and for clearly erroneous findings of fact).

246. *See, e.g.*, Volt Info. Scis., Inc. v. Bd. of Trs. of the Leland Stanford Junior Univ., 489 U.S. 468, 478 (1989) (explaining that the FAA "simply requires courts to enforce privately negotiated agreements to arbitrate, like other contracts, in accordance with their terms"); HRH Constr. Corp. v. Bethlehem Steel Corp., 384 N.E.2d 1289, 1292 (N.Y. 1978) (noting that "[i]t has long been recognized that by agreement the parties may determine the procedures to be followed in arbitration"); Jennifer M. Rhodes, *Judicial Review of Partial Arbitral Awards Under Section 10(a)(4) of the Federal Arbitration Act*, 70 U. CHI. L. REV. 663, 680 (2003) (commenting that because arbitration is contractual the parties may structure the procedures to fit their needs).

247. *See* Jan William Sturner, *Arbitration, Labor Contracts, and the ADA: The Benefits of Pre-Dispute Arbitration Agreements and an Update on the Conflict Between the Duty to Accommodate and Seniority Rights*, 21 U. ARK. LITTLE ROCK L. REV. 455, 455 (1999) (noting that potential disputants may prefer alternatives to traditional litigation because of the "procedural complexities and rigidity often associated with the court system").

248. *See* Yasuda Fire & Marine Ins. Co. of Eur. v. Cont'l Cas. Co., 37 F.3d 345, 353 (7th Cir. 1994) (acknowledging that arbitrators must "afford the parties a fundamentally fair hearing"); British Ins. Co. of Cayman v. Water St. Ins. Co., 93 F. Supp. 2d 506, 517 (S.D.N.Y. 2000) (noting that an arbitrator's denial of fundamental fairness to a party provides grounds for vacatur under the FAA); *see also* 9 U.S.C. § 10(a)(3) (2012) (providing that a court may vacate an arbitration award "where the arbitrators were guilty of misconduct in refusing to postpone the hearing, upon sufficient cause shown, or in refusing to hear evidence pertinent and material to the controversy; or of any other misbehavior by which the rights of any party have been prejudiced").

249. *See* EDMONSON, *supra* note 235, § 1.1 (explaining that arbitration tribunals do not rely on the established rules of procedure, evidence, substance, and appellate review typically applicable to judicial

requirements, discovery, motions practice, and appeals, all of which prolong litigation, impose considerable costs, and delay resolution of the dispute.[250] Judicial review of arbitration awards is narrowly circumscribed.[251] The Federal Arbitration Act (FAA) provides for the vacatur of awards where the misconduct of an arbitrator or one of the parties affected the proceedings or where the arbitrators exceeded their authority.[252] Some courts will nullify awards based on an error of substantive law but only if the arbitrators manifestly disregarded the law, a standard requiring that the arbitrators knew controlling law yet intentionally flouted it.[253] Other courts, relying on *Hall Street Assocs., L.L.C. v. Mattel, Inc.*,[254] will not vacate an award even where the arbitrator manifestly disregarded the law.[255]

B. Expertise

Section IV showed that judges have the necessary expertise to decide challenges to executive compensation. If arbitrators were charged with deciding challenges to executive compensation, they would exercise an even greater degree of competence than judges. The reason is simply that arbitrators are selected because of their expertise.[256] Arbitration organizations, such as the American Arbitration Association, have standard rules to aid the parties in the selection process.[257] Arbitrators deciding executive compensation cases would have expertise in compensation matters and the background and experience that the parties desire because the parties would choose the arbitrators for those very reasons. Judges may be qualified to decide executive compensation cases, but judiciously selected arbitrators are unquestionably more qualified.

proceedings). See *infra* Part V.C.1 for a fuller discussion of the point that the law does not bind arbitrators.

250. *See* Thomas J. Stipanowich, *The Arbitration Penumbra: Arbitration Law and the Rapidly Changing Landscape of Dispute Resolution*, 8 NEV. L. J. 427, 432 (2007) (stressing the breadth of procedures prescribed in arbitration agreements). *But see* Brunet, *supra* note 236, at 1461–62 (discussing the informal procedures of arbitration and concluding that although arbitrators rarely enforce the rules of evidence, a growing trend is to allow some discovery and motions practice).

251. PETER B. RUTLEDGE, ARBITRATION AND THE CONSTITUTION 46–48 (2013) (discussing the narrow scope of judicial review of arbitration awards).

252. 9 U.S.C. § 10(a)(3).

253. *See, e.g.*, T.Co Metals, LLC v. Dempsey Pipe & Supply, Inc., 592 F.3d 329, 339–40 (2d Cir. 2010) (holding that the manifest disregard standard survived as a ground of review under section 10 of the FAA pursuant to *Hall Street Associates v. Mattel, Inc.*, 552 U.S. 576, 577 (2008), which held that sections 10 and 11 of the FAA provide the exclusive grounds for vacatur); Comedy Club, Inc. v. Improv West Assocs., 553 F.3d 1277, 1290 (9th Cir. 2009) (same); Coffee Beanery, Ltd. v. WW, L.L.C., 300 F. App'x. 415, 418–19 (6th Cir. 2008) (holding that manifest disregard survived *Hall Street* as a nonstatutory ground of review).

254. 552 U.S. 576, 578 (2008) (holding that the FAA provides the exclusive grounds for vacating an arbitration award and therefore implying rejection of the manifest disregard standard).

255. *See, e.g*., Frazier v. Citifinancial Corp., 604 F.3d 1313, 1324 (11th Cir. 2010) (holding that the manifest disregard standard did not survive *Hall Street*); Citigroup Global Mkts., Inc. v. Bacon, 562 F.3d 349, 358 (5th Cir. 2009) (same).

256. Charles J. Moxley, Jr., *Selecting the Ideal Arbitrator*, 60 DISP. RESOL. J. 24, 25 (2005).

257. *See, e.g.*, AM. ARBITRATION ASS'N, COMMERCIAL ARBITRATION RULES AND MEDIATION PROCEDURES (INCLUDING PROCEDURES FOR LARGE, COMPLEX COMMERCIAL DISPUTES) R. 11(a) (2009) (providing that the American Arbitration Association will provide the parties with a list of ten qualified arbitrators); *id.* R. 12(a) (providing that the parties may select any arbitrator they wish).

C. Nonjudicial Decision Making

The business judgment rule, when applied to most day-to-day business decisions, benefits society by keeping government officials out of the affairs of business.[258] In executive compensation cases, the business judgment rule excludes a particular species of government official—the judiciary—from interfering with executive compensation decisions. The problem is that the business judgment rule leaves a vacuum, allowing preposterous compensation packages to stand without an oversight mechanism. When corporations delegate the authority to decide executive compensation controversies to arbitrators, they remove decision-making power from the hands of government. If corporations shifted executive compensation cases from the judiciary to privately selected arbitrators, both the corporations and society as a whole would benefit. Section II showed how the business judgment rule, the demand rule, and other legal doctrines interfere with the fair disposition of shareholder challenges to executive compensation. Section IV showed that the policy justifications for these legal rules do not apply to cases raising such challenges. Arbitrating such cases would obviate the problems posed by the inapt application of these doctrines because arbitrators are not bound by substantive law. These doctrines would, by operation of an arbitration agreement, become either optional or even unavailable to the arbitrators in their decision-making process.[259]

1. Freedom from Traditional Legal Rules

As Justice Blackmun succinctly observed: "[A]rbitrators are not bound by precedent."[260] A leading scholar of arbitration law, Professor Edward Brunet has similarly noted: "Arbitrators are not compelled to apply rules of substantive law. The weight of authority permits an arbitrator to 'do justice as he sees it' and fashion an award that embodies the individual justice required by a given set of facts."[261] Professor Domke stated the proposition as follows:

> It is true that the arbitrator is not obliged to follow formal rules as they prevail in court procedures; rules of evidence, burden of proof, and other court action devices are relaxed when arbitrators face such issues. Moreover, arbitrators, in reaching their determination, may disregard the strict and traditional rules of law.[262]

Of course, even arbitrators, with all the flexibility the law affords them, must apply norms to resolves disputes before them. Arbitration does not condone decisional anarchy. Freedom from procedural and substantive legal strictures is not freedom from

258. See *supra* Part III.A for a discussion of the purported benefits of the business judgment rule.

259. *See infra* notes 260–63 and accompanying text for a discussion of the rule that arbitrators are not bound by procedural or substantive principles of law.

260. Shearson/American Express, Inc. v. McMahon, 482 U.S. 220, 259 (1987) (Blackmun, J., concurring in part and dissenting in part).

261. Edward Brunet, *Arbitration and Constitutional Rights*, 71 N.C. L. REV. 81, 85 (1992). Brunet goes on to note: "Although it would be incorrect to say that substantive rules play no role in the informal style of arbitration, arbitrators, unlike judges, are not bound to use substantive law. This freedom from substantive rules creates a milieu in which arbitrators can ignore the law when making decisions." *Id.* (footnote omitted).

262. EDMONSON, *supra* note 235, § 30:2.

fair decision making. A fair decision must be measured against a reasonable standard, even if that standard is not prescribed by the formal rules of law.[263]

Courts characterize the business judgment rule as both an evidentiary presumption and a substantive rule of law.[264] Similarly, the demand rule for derivative suits is a procedural rule, which incorporates the business judgment rule.[265] Whether one regards these rules as procedural or substantive, arbitrators may ignore them. As Professor John Coffee has stated, "[i]n an arbitration proceeding where the arbitrators may examine the substantive issue from a more equitable perspective, the business judgment rule, and maybe the demand rule, may get less attention than they would receive in the Delaware Chancery Court."[266] Professor Coffee was concerned that arbitrators might ignore the business judgment rule and demand rule, which "are very important protections for corporate officers and directors."[267] This concern, however, does not apply to arbitrators resolving challenges to excessive executive compensation. In such cases, the business judgment rule and demand rule operate as an impediment to reigning in abusive pay packages. Appointed by businesses to resolve claims of excessive compensation, arbitrators, as expert nonjudicial decision makers, are in an ideal position to provide leverage against corporate giveaways.

2. Arbitrators as Agents

Nathan Isaacs has persuasively argued that arbitrators, in addition to acting as judge substitutes, function as agents of parties to arbitration agreements.[268] One reason

263. *See* Soia Mentschikoff, *Commercial Arbitration*, 61 COLUM. L. REV. 846, 866 (1961) (explaining that arbitrators must adopt decision-making norms). Professor Mentschikoff states:

> Any decision of the question of who is right in a dispute situation, however, requires the use by the deciders of a set of norms or standards against which the conduct involved in the dispute, as it is perceived by the deciders, is to be measured, because wrongness or rightness can never be a question of fact but is always a matter of judgment as to values. In both the formal legal and the arbitration systems the parties and their counsel can and frequently do suggest particular norms or rules of law as being *the* most relevant to the dispute involved, but the deciders are free to accept or reject the suggested norms.

Id.

264. *See, e.g.*, Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 360 (Del. 1993) (describing the business judgment rule as a "procedural guide," an evidentiary "presumption," and a "substantive rule of law").

265. *See, e.g.*, *In re* Goldman Sachs Grp., Inc. S'holder Litig., No. 5215-VCG, 2011 WL 4826104, at *12 (Del. Ch. Oct. 12, 2011) (applying the business judgment rule to determine if the plaintiff was excused from making demand on the board of directors).

266. John C. Coffee, Jr. & Constantine Katsoris, *Introductory Remarks*, 63 FORDHAM L. REV. 1599, 1601 (1995).

267. *Id.*

268. Nathan Isaacs, *Two Views of Commercial Arbitration*, 40 HARV. L. REV. 929, 932–33 (1927); *see also* Thomas J. Stipanowich, *Punitive Damages and the Consumerization of Arbitration*, 92 NW. L. REV. 1, 5 (1997) (recognizing that Isaacs posed two alternative views of arbitration, the first inviting comparisons to judges and the second drawing parallels to agents charged with fulfilling the will of the parties as expressed in their private contracts).

Some courts have adopted the view that arbitrators act as substitutes for judges. *See* Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S. 614, 628 (1985) (declaring that "[b]y agreeing to arbitrate a statutory claim, a party does not forgo the substantive rights afforded by the statute; it only submits to their resolution in an arbitral, rather than a judicial, forum"); Collins v. Oliver, 23 Tenn. 439, 440 (1844) (insisting for this characterization is that, as discussed above, arbitrators need not apply the rules of substantive law. This view of arbitration applies particularly well to the arbitration of executive compensation claims because the purpose of arbitrating executive compensation claims would be to free the decision maker from undesirable legal constraints. As agents of the shareholders and corporations, arbitrators would be invested, by operation of the arbitration agreement, with the contractual and fiduciary duties to exercise their authority fairly within the reasonable bounds of their discretion. By doing so, they would have latitude in resolving claims of corporate waste and charges brought against officers and directors for breach of fiduciary duty.

Isaacs also argues that arbitrators act as agents insofar as "they are charged with the power as well as the duty of making a contract for the parties."[269] This view of arbitration also applies to the arbitration of executive compensation controversies. Arbitration agreements might affirmatively instruct arbitrators not to apply rules of procedural and substantive law. Such agreements might also instruct arbitrators not only to review compensation arrangements for reasonableness but also to determine reasonable levels of compensation based on their sense of fairness. Selected for their expertise in compensation matters, arbitrators would function similarly to compensation consultants except that their judgments, rather than advisory, would be binding. This is not to suggest that directors should or even could delegate to arbitrators broad authority to determine compensation packages.[270] However, if granted the authority, arbitrators could, in their dual role as judge substitutes and agents, not only

that "[a]n arbitrator is not an agent . . . but [] a person vested with power by the law to examine and determine the matters in controversy"); Richard E. Speidel, *Contract Theory and Securities Arbitration: Whither Consent?*, 62 BROOK. L. REV. 1335, 1341–42 (1996) (arguing that the Supreme Court has implicitly adopted the judicial-substitute model of arbitration).

Other courts and commentators prefer to characterize arbitrators as agents of the parties. *See* Babb v. Stromberg, 14 Pa. 397, 399 (1850) (maintaining that an arbitration "award is an act of the parties performed through their agents, and assented to in advance"); Paul F. Kirgis, *The Contractarian Model of Arbitration and Its Implications for Judicial Review of Arbitral Awards*, 85 OR. L. REV. 1, 33 (2006) (arguing that the contemporary reality is that arbitrators act as agents of the parties rather than as "deputized semipublic referees"); *see also generally* Olga K. Byrne, *A New Code of Ethics for Commercial Arbitrators: The Neutrality of Party-Appointed Arbitrators on a Tripartite Panel*, 30 FORD. URB. L.J. 1815 (2003) (citing cases that have taken both sides of the issue).

Under either theoretical view, arbitration is ideally suited to resolve challenges to excessive compensation. Since, under the proposal in this Article, executive compensation disputes would fall to arbitration rather than to litigation, the substitute-judge theory would seem to apply. This conclusion follows from the duty of arbitrators to provide a dispute-resolution forum where both parties expect equal and fair treatment under hearing procedures, even if the strict requirements of due process do not apply. *See* Compania Chilena de Navegacion Interoceanica, S.A. v. Norton, Lilly & Co., 652 F. Supp. 1512, 1515 (S.D.N.Y. 1987) (stating that a court will vacate an arbitration award depriving a party of a fundamentally fair hearing); Kenneth R. Davis, *Due Process Right to Judicial Review of Arbitral Punitive Damages Awards*, 32 AM. BUS. L.J. 583, 601–02 (1995) (commenting that, although due process does not apply to commercial arbitration, arbitrators must meet fundamental standards of fairness). Yet, as argued above, the arbitration of executive compensation disputes fits even snugger into the agency model of arbitration.

269. Isaacs, *supra* note 268, at 932.

270. *See* JAMES D. COX & THOMAS LEE HAZEN, TREATISE ON THE LAW OF CORPORATIONS § 9:19 (2012) (discussing the limitations on the delegation of board powers); Ralph H. Delforge, *Corporations—Non-Delegable Powers of Board of Directors*, 34 MARQ. L. REV. 48, 50–51 (1950) (explaining that, as a general rule, directors may delegate ministerial powers but not discretionary powers).

review compensation agreements for excessiveness but also they could forge reasonable ones.

VI. THE ARBITRABILITY OF SHAREHOLDER DERIVATIVE COMPENSATION CLAIMS

Two additional issues must be resolved to make a credible case for arbitrating shareholders challenges to excessive executive compensation claims. The first is the threshold issue whether shareholder derivative claims are even subject to arbitration, and the second is how to implement the requirement that compensation claims go to arbitration rather than to court.

A. The Arbitrability of Shareholder Derivative Suits

A substantial body of authority holds shareholder derivative claims arbitrable.[271] In *In re Salomon Inc. Shareholders' Derivative Litigation*,[272] shareholders brought a derivative action alleging that several directors of Salomon Brothers and its subsidiary Salomon Inc. had violated § 10(b) of the Securities Exchange Act and their fiduciary duties by failing to disclose unlawful trading activities at Salomon Brothers.[273] Relying on various arbitration agreements with the NYSE, the individual defendants, presumably to avoid the strict judicial application of federal securities law, moved to compel arbitration.[274] The case presented a conflict of policies. On the one hand, Judge Patterson was alert to the pro-arbitration policy expressed in the FAA and in a series of supportive Supreme Court decisions.[275] In *Moses H. Cone Memorial Hospital v.*

271. *See, e.g.*, Ernst & Young Ltd. v. Quinn, No. 09-CV-1164 (JCH), 2009 WL 3571573, at *3 (D. Conn. Oct. 26, 2009) (recognizing agreement to arbitrate shareholder derivative claims); Oviedo v. Grace, No. B188018, 2007 WL 316519, at *4 (Cal. Ct. App. Feb. 5, 2007) (compelling arbitration of a shareholder derivative suit alleging breach of fiduciary duty and fraud against members of Pacific Imaging, an LLC in the business of diagnostic imaging); Regalado v. Cabezas, 959 So. 2d 282, 283 (Fla. Dist. Ct. App. 2007) (recognizing stipulation to submit shareholder derivative suit to arbitration); Maresca v. La Certosa, 569 N.Y.S.2d 111, 111 (N.Y. App. Div. 1991) (upholding agreement to arbitrate shareholder derivative action alleging breach of fiduciary duties and corporate waste). *But see* Butterworth v. Morgan Keegan & Co., No. 2:12-CV-00337-TMP, 2012 WL 4732886, at *12 (N.D. Ala. Sept. 28, 2012) (suggesting that compliance with the shareholder derivative demand rule and the other procedural requirements for commencing a shareholder derivative suit operated as preconditions for arbitrating a shareholder derivative suit). It should be noted that the above cases did not involve publicly traded companies where representation and notice issues would be more acute than they would be in closely held corporations or LLCs. *See* Jeffrey Sanborn, Note, *The Rise of "Shareholder Derivative Arbitration" in Public Corporations:* In Re Salomon Inc. Shareholders' Derivative Litigation, 31 WAKE FOREST L. REV. 337, 359–61 (1996) (discussing the advent of the arbitrability of shareholder derivative claims and suggesting that amending articles of incorporation or passing corporate bylaws are two effective methods for adopting arbitration as a method of corporate dispute resolution); Andrew J. Sockol, Comment, *A Natural Evolution: Compulsory Arbitration of Shareholder Derivative Suits in Publicly Traded Corporations*, 77 TUL. L. REV. 1095, 1115–16 (2003) (favoring the arbitrability of derivative claims asserted against officers and directors of publicly traded companies and suggesting that officers and directors individually sign arbitration agreements).

272. No. 91 Civ. 5500 (RPP), 1994 WL 533595 (S.D.N.Y. Sept. 30, 1994).

273. *Salomon*, 1994 WL 533595, at *1. The allegation was that Salomon Brothers had bid for and acquired U.S. Treasury securities in excess of the 35% limit prescribed by the Treasury Department. *Id.*

274. *Id.*

275. *Id.* at *8.

Mercury Construction Corp.,[276] for example, the Supreme Court emphasized that "any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration."[277] On the other hand, Judge Patterson was concerned with policy considerations that argued against arbitrating shareholder derivative suits. First, a decision reached by the officers and directors of a corporation to submit shareholder derivative claims to arbitration might deprive shareholders of the procedural and substantive rights afforded in litigation.[278] Second, Federal Rule of Civil Procedure 23.1, the rule governing shareholder derivative suits, prescribes safeguards for shareholders that arbitrators might not follow, either by design or ignorance.[279] One such safeguard in Rule 23.1 provides that the court must determine whether the named plaintiffs will "fairly and adequately represent the interests of [] shareholders."[280] Rule 23.1 also provides that shareholder derivative actions shall not be dismissed or compromised without court approval and notice to the shareholders.[281]

In resolving this clash of policies, Judge Patterson concluded that, since the FAA is a statute conferring substantive rights,[282] the FAA took precedence over Rule 23.1, a mere procedural rule, which cannot abrogate such substantive rights.[283] It was, however, unclear whether shareholder derivative suits were arbitrable under the rules of the NYSE.[284] Judge Patterson therefore directed the case to the NYSE for a determination of whether its rules permitted such arbitration.[285]

Despite some misgivings, Judge Patterson upheld the arbitrability of shareholder derivative suits. His misgivings are particularly unpersuasive to cases challenging excessive executive compensation. When charged with securities law violations, officers and directors would likely prefer to submit the dispute to arbitrators, who, unlike judges, might not insist on the strict application of securities law. In

276. 460 U.S. 1 (1983).

277. *Moses H. Cone Mem'l Hosp.*, 460 U.S. at 24–25; *see also* Dean Witter Reynolds, Inc. v. Byrd, 470 U.S. 213, 221 (1985) (observing that "[t]he preeminent concern of Congress in passing the [FAA] was to enforce private agreements . . . [which] requires that we rigorously enforce agreements to arbitrate"); Kenneth R. Davis, *The End of an Error: Replacing "Manifest Disregard" with a New Framework for Reviewing Arbitration Awards*, 60 CLEV. ST. L. REV. 87, 107–08 (2012) (commenting on the Supreme Court's ardent support of arbitration). The Supreme Court derives its pro-arbitration policy from the FAA. Section 2 of the FAA provides that arbitration agreements "shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract." 9 U.S.C. § 2 (2012).

278. *Salomon*, 1994 WL 533595, at *6.

279. *Id.*

280. *Id.* at *7 (quoting FED. R. CIV. P. 23.1).

281. *Id.* (citing FED. R. CIV. P. 23.1).

282. *See* Southland Corp. v. Keating, 465 U.S. 1, 12 (1984) (declaring that the FAA creates substantive rights).

283. *See Salomon*, 1994 WL 533595, at *7–8 (describing how 28 U.S.C. § 2072(b) dictates that the provisions set forth in the Federal Rules of Civil Procedure may not abrogate any federal substantive rights).

284. *Id.* at *9. The Financial Industry Regulatory Authority (FINRA) has replaced both the NASD and NYSE as the regulatory authority administering securities arbitration. FINRA rule 12205 provides: "Shareholder derivative actions may not be arbitrated under the Code." FINRA R. 12205 (2008).

285. *Salomon*, 1994 WL 533595, at *12. The NYSE decided that its rules disallowed the arbitration of shareholder derivative claims. Since the arbitration agreements directed arbitration *only* to the NYSE, Judge Patterson subsequently set the matter down for trial. *In re* Salomon Inc. S'holders Derivative Litig., 68 F.3d 554, 561 (2d Cir. 1995). The Second Circuit affirmed Judge Patterson's decision. *Id.*

compensation cases, however, the officers and directors would not press for arbitration because arbitrators might not impose restraints such as the business judgment rule and the demand rule to short-circuit challenges to excessive compensation. Thus, arbitration would promote, not defeat, the shareholders' objective to prevent the looting of corporations by the granting of obscene pay packages.

It should be noted, too, that arbitrating class actions raises issues of adequacy of representation and notice similar to those raised when arbitrating shareholder derivate suits. In the class action context, an arbitrator might fail (1) to determine whether a putative class representative adequately represents the interests of the class and (2) to provide adequate notice of the class arbitration to potential members of the class. In *Stolt-Nielsen S.A. v. AnimalFeeds International Corp.*,[286] the Supreme Court held class actions arbitrable if the parties so agreed.[287] Writing for the majority, Justice Alito noted that class arbitration differs from bilateral arbitration in that it binds hundreds if not thousands of claimants, most of whom are not present at the hearings, and therefore, for class arbitration to proceed, the agreement to arbitrate as a class must be clear.[288] It is probable that the Supreme Court, if presented with the issue of whether shareholder derivative suits are arbitrable, would reach the same conclusion.

As one might expect, the current judicial trend is to enforce agreements to arbitrate shareholder derivative claims. In *Frederick* v. *First Union Securities, Inc.*,[289] for example, a shareholder of En Pointe Technologies brought a shareholder derivative suit, alleging that certain officers and directors of En Pointe, in concert with others, engaged in a scheme to inflate the price of En Pointe stock and to profit from the sale of the stock.[290] The complaint charged that En Pointe's market maker, First Union, was a participant in this unlawful "pump and dump" scheme.[291] Relying on an arbitration agreement between En Pointe and First Union, First Union sought to compel arbitration of the shareholder derivative suit.[292] The Superior Court of Los Angeles County denied the motion.[293] Holding that En Pointe's shareholders stood in its shoes, the appellate court reversed the order of the lower court and ruled that the arbitration agreement applied to the shareholders.[294]

Since shareholder-derivative controversies appear to be arbitrable, the remaining issue is how to implement the arbitration of challenges to excessive executive compensation.

286. 559 U.S. 662 (2010).

287. *Stolt-Nielsen S.A.*, 559 U.S. at 684.

288. *Id.* at 684–86. Justice Alito also noted that class arbitration differs from bilateral arbitration in that in class arbitration confidentiality and privacy may be compromised. *Id.* at 686.

289. 122 Cal. Rptr. 2d 774 (Cal. Ct. App. 2002).

290. *Frederick*, 122 Cal. Rptr. 2d at 775.

291. *Id.* at 777.

292. *Id.* at 775–76.

293. *Id.* at 776.

294. *Id.* at 779.

B. The Delegation of Executive Compensation Cases to Arbitrators

By amending the articles of incorporation or by passing an appropriate bylaw, a corporation could authorize the arbitration of claims challenging executive compensation agreements.[295] In addition, the corporation would have to require officers and directors to agree to arbitrate compensation disputes.[296]

The grant of authority to the arbitrators would determine the scope of their authority. If a corporation granted arbitrators the authority to render a decision on a claim challenging excessive executive compensation, the rules of law, mandatory for courts to apply, would be optional. Arbitrators would have the flexibility to rule according to their sense of justice and common sense. They might decide, without instructions to the contrary, to apply the business judgment rule, the demand rule, the law of the fiduciary duties of care, loyalty, and good faith, and the law of corporate waste. In short, they might choose to follow the law that a court would apply. They might benchmark their decision to the compensation practices of similarly situated companies or give weight to the testimony of compensation consultants who might advocate astronomical pay levels. But if they were offered evidence that such pay levels were 300, 400, or even 500 times the pay of the average employee of the company, some arbitrators might inject their sense of fairness to guide their decision making. Rather than benchmarking to the extravagant practices of other U.S. companies, arbitrators might follow the lead of other countries where the pay of CEOs compared to the pay of rank-and-file workers is significantly lower than in the United States.[297] CEO pay in the top 100 Japanese companies, for example, is one-ninth of CEO pay in the top 100 U.S. companies.[298] Alternatively, arbitrators might borrow from progressive U.S. companies that have established reasonable ratios between the average pay of their workers and the pay of their top executives.[299]

The amendment or bylaw might direct the arbitrators to disregard the business judgment rule and other rules of corporate law. In such cases, the arbitrators would rely on their sense of fairness to determine the reasonableness of the challenged compensation agreement. Aside from the question of the excessiveness of a

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295. *See* Sanborn, *supra* note 271, at 359, 361 (discussing the advent of the arbitrability of shareholder derivative claims and suggesting that amending articles of incorporation or passing corporate bylaws are two effective methods for adopting arbitration as a method of corporate dispute resolution).

296. *See id.* at 362 (noting that it would be difficult for a corporation to agree on a forum for its claims unless the corporation's officers and directors were also parties to the agreement).

297. Blake H. Crawford, *Eliminating the Executive Overcompensation Problem: How the SEC and Congress Have Failed and Why the Shareholders Can Prevail*, 2 J. BUS. ENTREPRENEURSHIP & L. 273, 288–89 (2009) (citing empirical evidence that a CEO's pay typically increases after the CEO has implemented a reduction in force).

298. *See* Kenji Hall, *No Outcry About CEO Pay in Japan*, BLOOMBERG BUSINESSWEEK (Feb. 10, 2009), http://www.businessweek.com/globalbiz/content/feb2009/gb20090210_949408.htm (reporting that from 2004–06, the CEOs of Japan's top 100 companies earned an average of only $1.5 million and the CEOs of Europe's top 100 companies earned an average of $6.6 million, while the CEOs of the U.S.'s top 100 companies earned an average of $13.3 million).

299. *See* Leslie Kwoh, *Firms Resist New Pay-Equity Rules*, WALL ST. J., June 26, 2012, at B8 (noting that some U.S. companies have instituted policies limiting executive pay to a multiple of the average pay of all company employees).

compensation arrangement, arbitrators might also face issues of director liability. Although a duly adopted exculpatory provision might shield a director from liability for gross negligence, such an exculpatory provision could not shield a director for more egregious violations arising from self-dealing or intentional wrongdoing.[300]

To protect the company from frivolous claims, the amendment or bylaw might include a standing requirement. Such a requirement might restrict the right to commence arbitration to shareholders owning at least one thousand shares of common stock for a period of at least one year prior to the date of commencement of arbitration, or it might impose even more stringent requirements. To avoid impairing the rights of any shareholder to seek redress, shareholders who did not meet the standing requirement would retain the right to commence derivative suits.[301] This approach might result in the added benefit of discouraging such derivative suits because shareholders ineligible to arbitrate might defer to those who were eligible.

Management would naturally oppose such an amendment or bylaw because it would threaten their gold-plated lifestyles. Shareholders would have to wage a proxy fight, which would undoubtedly encounter vehement opposition from both the directors and managers. Sufficient organization and publicity on social media, newspapers, and television might overcome that opposition. Shareholders mobilized public opinion against Grasso's $187 million windfall.[302] The result was that he never received his $48 million bonus.[303] Shareholders have waged many successful proxy fights.[304] The success of such a fight turns on a level of commitment and perseverance that will match the determination of the agents of managerial greed.

VII. CONCLUSION

The titans of industry make titanic sums. Their compensation may be more a function of their power than their worth. Deciding whether they are overpaid is subjective, but the method for determining their pay is, in many instances, outrageous. We, as a society, generally let the free market determine the prices of goods and services. We put our faith in the forces of supply and demand. The compensation packages of CEOs and other top-level managers, however, are not decided by the neutral economic forces of a free market system. Nor are they necessarily linked to the proven value of managers as demonstrated by their performance. Nor are they linked necessarily to the value that a manager brings to a company when that manager's contribution is compared to the potential contribution of a replacement. CEOs are

300. The Delaware General Corporation Law permits articles of incorporation to exculpate directors for breach of the duty of care but not for breach of the duty of loyalty. Del. Code Ann. tit. 8, § 102(b)(7) (West 2014).

301. *See* FED. R. CIV. P. 23.1(a) (granting the right to commence shareholder derivative suits to "one or more shareholders").

302. Jenny Anderson, *Stock Exchange's Former Chief Wins Court Battle to Keep Pay*, N.Y. TIMES, July 2, 2008, at A1, A16, *available at* 2008 WLNR 12377720.

303. *Id.*

304. *See* Megan Davies, *In Proxy Fights, Odds in Favor of Dissidents*, REUTERS (Aug. 23, 2007), http://blogs.reuters.com/reuters-dealzone/2007/08/23/after-all-the-punches-proxy-fights-win-half-the-time/ (showing that dissidents are successful in approximately 50% of proxy fights).

viewed as irreplaceable until they fail. Often plagued with conflicts of interests, inertia, and psychological pressures, self-perpetuating boards of directors decide executive pay levels. This is not the free market system at work. If we have faith in the system that sets executive pay, our faith is misplaced. Benchmarking compensation decisions to the pay scales of competitors whose directors are beset with similar corrupting influences merely deepens the problem. The problem grows deeper still because, in contriving to outdo competitors, companies tend to reach for the upper end of the pay scale.

Everyone derives a sense of value from interacting with markets that set prices for goods and services. Paying $5 for a gallon of gasoline seems high because we are used to paying somewhat less. Paying $10 for a gallon of gasoline would seem exorbitant because a $10 price tag would represent more than a doubling of the current price. Many concerned observers believe that the price tag for a corporate executive is as inflated as gasoline priced at $50 per gallon.

Market forces like speculation and supply shortages brought about by OPEC might lead to sudden leaps in the price of oil. Then again, oil gluts result in falling prices. Executive compensation hardly ever falls. When it comes to executive compensation, the invisible hand of the marketplace seems to have lost its grip. CEO pay spirals ever upward, although the only apparent drivers of the cost of business leadership are what directors are willing to authorize and what shareholders are willing to tolerate. The proof of the broken linkage between executive compensation and neutral market forces is the stagnation of the pay of ordinary wage earners compared to the meteoric rise in the pay of high-level corporate executives.

When directors hike executive pay to stratospheric levels, outraged shareholders sometimes institute derivative suits. These suits often fail, however, because, absent proof of egregious misconduct, corporate law shields directors from liability and shelters their decisions from judicial scrutiny. Unless shareholders can show that a majority of directors acted in bad faith—which usually requires proof of intentional improprieties—the business judgment rule and other rules of procedural and substantive law conspire against the interests of shareholders and their corporations.

Arbitration offers a solution to the executive-pay scandal. An efficient method of alternative dispute resolution, arbitration carries an enormous benefit compared to litigation: arbitrators are not required to follow the rules of procedural and substantive law. Rather, they may apply fair and workable rules of decision based on their experience, expertise, and sense of justice. Because of the business judgment rule and other corporate law impediments, courts rarely consider whether a compensation package is unreasonably excessive. Freed from these constraints, arbitrators, unlike judges, may take a hard look at the numbers. They might decide that a giveaway such as the $130 million prize lavished on Michael Ovitz for failing at Disney is simply too much. They might decide that a massive payout such as the $187 million package resulting from Grasso's manipulations is unacceptable. They might decide to stop the abuse.