

# WASTE NOT (SHAREHOLDERS) WANT NOT<sup>1</sup>

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In today's poor economic climate, there is an increasing intolerance with executives who are receiving massive compensation packages despite the poor performance by the corporation or decline of the corporation's stock. Despite a history of deferring to the decisions of the directors, courts are beginning to become equally as intolerant.

Traditionally, courts are "pro-business" and recognize the "business judgment rule," which defers to the decisions of a corporation's directors, even if those decisions turn out poorly for the company in hindsight. Loosely speaking, the business judgment rule is 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. This is traditionally a very difficult presumption to rebut. Particularly, waste claims for executive compensation are traditionally difficult to plead because the test for determining waste claims, especially in the context of executive compensation, is so rigid. *See e.g., Beha v. Martin*, 171 S.W. 393 (Ky. 1914) ("The directors of a corporation...have large powers in the selection of, and the salaries to be paid to, its officers, with which discretion the courts will not ordinarily interfere."). The business judgment rule as it pertains to waste states that an executive's business decision will be upheld unless a corporation or shareholder, who bears the burden of proof, can prove that no person of ordinary, sound judgment would have made that same decision. *See In re Citigroup Inc. Shareholder Derivative Litigation*, 964 A.2d 106 (Del. Ch. 2009) ("*Citigroup*").

In a recent notable decision, however, a Delaware Chancery Court upheld the Citigroup Inc.'s shareholders' claim for waste where Citigroup awarded its outgoing chief executive officer with a retirement package worth \$68 million even though Citigroup allegedly suffered a recent \$55 billion loss due to subprime lending. In *Citigroup*, Citigroup's shareholders alleged that Citigroup paid the multimillion-dollar compensation package to the departing CEO whose failures were allegedly responsible for the billion dollar loss. Despite dismissing all the shareholders' other claims against the directors relating to the loss because of the business judgment rule, the court concluded that the shareholders' claim for waste had merit and satisfied the business judgment test.

The *Citigroup* decision likely marks the beginning of a new era in waste jurisprudence. Nevertheless, shareholders should not yet begin racing to the courts with their waste claims. Plaintiff-shareholders still have a challenging road for proving waste claims. In the words of a Delaware court, "[A] board's decision on executive compensation is entitled to great deference.

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It is the essence of business judgment for a board to determine if a particular individual warrant[s] large amounts of money, whether in the form of current salary or severance provisions.” *Brehm v. Eisner*, 746 A.2d 244, 263 (Del. 2000). Rarely is a shareholder able to show that compensation is so one sided that “no person of ordinary sound judgment could conclude that the corporation has received adequate consideration.” *See Citigroup*.

As exemplified in the infamous *Walt Disney* case, the presumption of the business judgment rule is difficult to rebut, if not almost impossible. In 2005, shareholders of Walt Disney Company sued its directors for waste over the \$130 million exit package Michael Ovitz received after just 14 months of work. *In re Walt Disney Co. Derivative Litigation*, 907 A.2d 693 (Del. Ch. 2005). After a 37 day trial, the shareholders lost their case because they were unable to rebut the business judgment rule presumption. The chancery court’s decision was easily affirmed by the Delaware Supreme Court.

In addition to filing waste lawsuits, shareholders have other options to combat a company’s executive compensation decisions. One avenue for shareholders is a “books and records” request, which is a function of state law, and permits shareholders to inspect a company’s books and records. For example, under KRS 271B.020, a shareholder of a Kentucky corporation has the statutory right to view and inspect the books and records of the corporation. The shareholder must provide the corporation with five days written notice and must make the demand in good faith and for a proper purpose. KRS 271B.020(3)(a). Where a demand is made to review the corporate books and records, the burden of proof is on the corporation to present evidence that the request was not made for a proper purpose. *Bennett v. Mack’s Supermarkets, Inc.*, 602 S.W.2d 143 (Ky. 1979).

Shareholders can use the books and records request to investigate executive compensation decisions. The books and records request would allow shareholders to examine the corporation’s documents and determine if the board’s approval of a compensation package or bonus was proper and supported by the director’s value to the corporation. Shareholders may also make a demand on the board of directors, outlining the perceived problems and requesting the company bring suit, or to wage proxy requests and seek a seat on the board of directors.

In light of the current economic turmoil, corporations should not be surprised to face these types of shareholder challenges if they choose to award an executive a large compensation package, particularly if the corporation is not performing well. Consequently, corporations should consider the following when addressing these challenges. First, boards and compensation committees should establish and maintain a reasonable, written process for making their compensation decisions and that process should be consistently followed. Second, boards should fully document all compensation decisions and the decisions should be heavily related to the actual value the executive has brought to the company. Third, if the compensation is tied to some measure of performance, then that measure should focus on the long-term viability of the corporation more so than any short-term measurements. Finally, compensation decisions should

never divert from the practices and procedures explained to shareholders, and all decisions should always be adequately and fully explained to the shareholders.

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