### Course: Corporations and Corporate Governance

#### Contents:
*Reading Materials, Sessions Three:*
The Law and Economics of Executive Compensation

### Instructor: Professor Robert J. Jackson, Jr.

#### Meeting Details:
Tuesday, July 26, 9:45 AM to 12:45 PM
Jerome Greene Hall

### Readings:
When we are reunited Tuesday morning, we will begin our work on corporate governance with one of the most controversial issues in U.S. corporate law today: how corporations pay their top managers, and especially their Chief Executive Officers, or “CEOs.” In preparation for our discussion, please review the following materials:


- *Jones v. Harris Associates L.P.*, 527 F.3d 627 (7th Cir. 2008) (Easterbrook, J.) (edited) (read only from the beginning of the case to 527 F.3d at 633 (paragraph ending with, “However weak competition may be”); *Jones v. Harris Associates L.P.*, 537 F.3d 728 (7th Cir. 2008) (Posner, J., dissenting from denial of rehearing en banc) (edited) (read only from beginning to the paragraph ending at the top of 537 F.3d at 732).

I very much look forward to discussing these materials with you during our morning session on Tuesday.
COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION

FOURTH EDITION

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EXECUTIVE COMPENSATION

8.1 Introduction

Viewed from a great height, corporation law can be seen to have two main social goals. The first is the facilitation of cooperative economic activity. This goal is advanced by all of the fundamental features of the corporate form that we discussed in Chapter 3—for example, powerful centralized managers appointed by the shareholder-elected board. The second great aim of corporate law is the efficient reduction of agency costs in this powerful managerial institution. This is especially true for companies that raise equity through public distribution of their shares. We say the efficient reduction of agency costs because steps taken to reduce managerial discretion may reduce not only agency costs but may also reduce the effectiveness of management as well. In theory, it is possible to have “too much of a good thing” in reducing agency costs.

The enforcement of the fiduciary duty of loyalty in derivative litigation is directed towards this second aim. But enforcing legal duties in court is a costly, ex post, and highly imperfect way to get senior managers to act in an appropriate way. An ex ante approach—that is, an approach that creates incentives for managers to “do the right thing” in the first place—would obviously be better, if feasible. In this context, it is generally agreed that “doing the right thing” would be to get corporate directors and senior officers to try in good faith to direct the corporation’s business with the goal of advancing its long-run corporate gain and, thus, the long-run financial interests of the company’s residual owners, the shareholders. But creating incentive systems that link managers’ personal interests with corporate wealth production is an extremely complex, problematic, and inherently imperfect activity. First, it is difficult to identify the best signals of “production.” Second, even if measures of production could be adequately identified, attributing that production to different members of the management team is often complicated. Third, whatever metric is chosen, those who will be paid in relation to it will have incentives to “game” the system, i.e., managing to maximize the metric rather than overall corporate performance. Even worse, as some of the corporate scandals of the past few years illustrate, managers might use guile or deception in order to maximize the metric.

These challenges are the central focus of this chapter. We also address the academic debate concerning how well public-company boards are in setting
these incentives (judged by the results the incentives generate) and the regulatory responses to the manifest problems associated with setting compensation. Finally, we address the necessarily quite limited role that judicial review can and does play in reviewing the results of corporate compensation plans.

8.2 The Challenge of Executive Pay

Lady Gaga earned approximately $90 million in 2010. Roger Federer earned $50 million, Leonardo DiCaprio nearly $80 million, and Oprah Winfrey has reportedly earned a whopping $275 million annually in recent years. Most CEOs and senior executives earn far less than these amounts. Yet while no one begrudges the hundreds of millions that Beyoncé, LeBron James, and Paul McCartney earn each year, to name just a few superstar celebrities, public outrage and Congressional scrutiny regularly focus on the compensation of public company CEOs and, to a lesser degree, their top management teams.

Why the difference? It might be argued that Oprah Winfrey “adds value” and “is clearly worth it,” while the value added by CEOs can’t possibly justify the large compensation packages that they often receive. But this argument falls short. Is the value created by Oprah Winfrey more than, say, the value that Steve Jobs created at Apple, or that Jamie Dimon adds at J.P. Morgan Chase? The fact is that public-company CEO’s wield enormous levers, and a 1 percent improvement in corporate value over the next best person can be just as large as, if not greater than, the value created by even the most talented superstar celebrity.

The reason, then, that executive pay holds a special place in the public debate (at least, in our view, the sophisticated public debate) is not the magnitude of the compensation received, but rather the way in which it is set. Because most CEOs sit on their company’s board of directors, setting their compensation is a form of self-dealing. Of course, boards establish mechanisms to try to emulate an arm’s length negotiation; for example, the compensation committee of the board, consisting entirely of independent directors, typically sets the CEO’s pay. But even with these devices, the effort for a truly arm’s-length negotiation is tempered by the soft ties that inevitably influence (and in many instances, help) the functioning of collegial bodies such as the board of directors. Executive pay, then, is the ultimate self-dealing transaction.

In addition to board-level soft ties, there are other practical realities. For example, the company’s general counsel and other top managers, not just the board, are often involved in the negotiations to bring a CEO in from the outside. But these managers will know that they will be working for the new CEO once she arrives. How does this factor shape the negotiation? One might argue that they will be tougher, to show the incoming CEO how they will perform when negotiating on the company’s behalf. Or they might be less tough, to please their new boss. Whatever the direction of the effect, it is clear that the intangible relationships cannot be completely extinguished, and CEO compensation remains a conflicted transaction. Note too that setting CEO pay, unlike all other self-dealing transactions, is essential for the proper functioning of the corporation. A board can avoid contracting with a
8.3 A Brief History of Executive Compensation in the U.S.

In the 1970s and 1980s, CEOs and other top executives were typically compensated like all other employees of the company, with most of their compensation coming in the form of an annual salary, and then an additional, discretionary bonus paid at the end of the year. The only difference between the CEO and other employees was that the CEO’s pay would be set by the compensation committee of the board; then the CEO would be responsible, directly or indirectly, for setting the pay for all other employees. During this
era, the level of CEO pay was not controversial; rather, most of the criticism focused on the way in which CEO's were compensated. The point was made convincingly by Professor Michael Jensen, then at the University of Rochester and later at the Harvard Business School, that CEOs had little, if any, financial incentive to maximize value for their shareholders: "CEO's are compensated like bureaucrats" was his famous claim. If the company did well, the CEO didn't get more money; and if the company did poorly, he didn't seem to feel it very much. The correlation between CEO compensation and overall firm performance was low.1

One implication of this observation was the potential for larger agency costs of management. If the CEO received a trivially small fraction of any benefits created for the corporation, and suffered only a trivially small fraction of any costs imposed, would he fly first class or business class? (Or even better, just buy a fleet of corporate jets?) Would he work 24/7 or leave the office at 3:00 p.m. on Fridays to play golf? Famous stories, such as RJR Nabisco CEO Ross Johnson flying his dog on the corporate jet at large expense to the corporation, fueled the popular perception during this era that the "private benefits of control" for public-company CEOs were large. Jensen and others argued that the particular compensation system that was commonplace during this era increased agency costs, at the expense of shareholder wealth maximization and overall corporate value.

Beginning in the 1990s, the idea of performance-based pay began to catch on with corporate boards. Although several metrics could have been used, such as revenue growth, earnings growth, or subjective assessments of performance, corporate boards during this era gravitated primarily to stock and stock-option compensation. Stock-based pay is straightforward: In addition to an annual salary and bonus, the CEO would receive a specified number of shares of the company at the beginning of each year. If the company did well, the CEO's stock would appreciate in value. Slightly less intuitive is stock-option compensation. A stock option in this context (technically a "call" option) is the right to purchase a share of stock from the company for a fixed price, known as the "strike price" of the option. If the strike price is the market price of the stock at the time the grant is made, as is normally the case, the option is an "at the money" option. If the strike price is lower than the current market price, the option is granted "in the money." And if the strike price is higher than the current market price, the option is granted "out of the money."

To take a simplified example, a company might grant its CEO the right to buy 100 shares of XYZ Corporation at the current share price of $100 per share. Typically, the option would have a ten-year exercise period (which is longer than exercise periods for options that trade in the financial markets), which means that if the share price of XYZ Corporation went above $100 (say, to $110), the CEO could exercise his right to buy 100 shares of the company at $100, and then sell those shares into the marketplace at $110. In this example, the CEO would make a profit of $10 per share X 100 shares = $1,000.

1. See, e.g., Michael C. Jensen & Kevin Murphy, Performance Pay and Top-Management Incentives, 98 J. Pol. Econ. 225 (1990) (calculating that CEOs receive, on average, $3.25 for every $1,000 increase in shareholder wealth).
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If, instead, the share price of XYZ Corporation stayed at or below $100 for the full ten-year exercise period, the CEO would have no incentive to exercise the options, and the options would expire unexercised.

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

Stock and stock-option compensation (collectively, "performance-based pay") exploded during the 1990s. The following chart documents the growth of CEO pay during this period and the dramatic shift to performance-based pay, going from virtually non-existent in 1980 to approximately two-thirds of total compensation for the median CEO by 2001:

² There is also "phantom stock," which provides a cash or stock bonus based on the stock price at some future date. If structured properly, phantom stock creates the same economic incentives for the manager as actual stock.
Clearly, some of this trend was encouraged and influenced by pay experts, directors, and other observers who sought to establish a tighter link between pay and performance. And indeed, by the late 1990s, the conventional wisdom was that the dramatic growth of performance-based pay had tightened the link considerably, thereby reducing agency costs and private benefits of control. CEOs and other top managers now had "skin in the game," which caused them to work harder than ever before to create value for shareholders.

While this story is persuasive, other factors were no doubt also at work in explaining the shift to performance-based pay in the 1990s. First, in 1993, Congress passed §162(m) of the Internal Revenue Code, which stated that compensation above $1 million for the CEO and any of the other four top officers would not be deductible to the corporation unless it was "performance-based compensation." Stock and stock-option compensation clearly qualified as "performance-based compensation," and therefore avoided the $1 million cap. Corporate boards took advantage of this exemption to load up their CEOs with stock and stock options.

In addition to a tax explanation for the shift in CEO pay, accounting rules likely played a role as well. Unless they were "in the money" at the time of the grant (which was rare), stock options were not an expense to the company under FASB rules, and therefore did not affect closely watched performance metrics such as earnings per share (EPS) and price-earnings ratios. In an efficient market, of course, accounting treatment of options should not matter because investors should "see through" accounting rules to understand that CEOs were taking value out of the company through stock options. In the real world, however, investors seemed to care about accounting measures, and boards, in turn, seemed to view stock-option compensation as a cheap tool for compensating the CEO, relative to salary, bonus, or stock. In 2004, FASB Statement No. 123 was issued, which required companies to expense the "fair market value" of options at the time of grant. But until then, it is no exaggeration to say that many boards viewed stock options as a "free" way to compensate the CEO.

4. The FASB (Financial Accounting Standards Board) is the private body charged by the SEC with developing generally accepted accounting principles (GAAP).
5. Although Rule 123 does not require a specific method for valuing the options, the vast majority of U.S. companies have used the Black-Scholes option pricing formula. Critics complain that the Black-Scholes formula overstates the value of options on the income statement; among other reasons, the Black-Scholes formula assumes that the option-holder is perfectly diversified, which is not the case for managers who are over-invested in their own companies. Even if their financial portfolios were perfectly diversified, managers' "human capital" is invested 100 percent in the company, and cannot be diversified.
6. The New York Stock Exchange and NASDAQ listing standards now require listed companies to seek shareholder approval for all stock-option plans except those that are offered as an inducement to new employees or in connection with a merger or acquisition. See www.nyse.com/pdfs/finalruletext3393A.pdf; nasdaq.com/emp/index.html (Rule 4550-5). Formerly, the NYSE and NASDAQ excluded "broadly based" option plans from required shareholder votes. In addition, all issuers must obtain shareholder approval of stock-option plans in order to qualify for favorable federal tax treatment, including exemption from the limits on deductibility under §162(m) of the IRC and special tax treatment for incentive stock options (ISOs).
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In short, tax and accounting rules might explain the shift to stock and stock-option compensation during the 1990s just as much as, if not more than, the effort to link pay to performance. Certain board practices during this time also call into question the pay-for-performance motivation. First, indexed options, which rewarded executives for performance relative to an industry peer group, were virtually non-existent during the 1990s. If option compensation were truly an effort to link pay to performance, it might be thought that executives should be rewarded for performance that exceeded the industry average. Instead, executives during the 1990s were able to ride the general upward trend in the stock market during this period. Even if the company under-performed its peer group, executives could make substantial money from their stock options if the market overall went up. For this reason, many commentators argued that non-indexed options did not effectively link pay to performance.

Another pay practice that was common during the 1990s was option repricing. If options were out of the money (or, more colloquially, “underwater”) at a particular company, the board might reset the strike price of the options at the current (lower) market price. Of course, this represented a windfall to executives, because their previously “out of the money” options now became substantially more valuable “at the money” options. Critics of this practice pointed out that if executives expected options to be repriced, then, yet again, the link between pay and performance had been severed. Defenders of the practice observed that “deep out of the money” options lost their incentive benefit, because there was little chance that these options would actually go into the money; repricing, then, restored the incentive benefit, which was an important purpose of option compensation in the first place.\(^7\)

The story thus far might explain why boards shifted the mix of compensation more towards stock and stock options, but what explains the overall growth of CEO pay during the 1990s and 2000s? Some argue that the CEO’s job became more demanding during the 1990s, with the globalization of product and capital markets and the increasing scale and complexity of operations at many corporations. Others point to the trend among corporate boards to hire outside, “superstar” CEOs during this period, who typically command higher compensation than comparable internal candidates.\(^8\) Certainly, these factors were at least part of the explanation for the overall growth of CEO pay.

In addition, it seems likely that important regulatory changes played a role as well. In 1993, in a clear nod to the Brandesian notion that “sunshine is the best disinfectant,” the SEC established new rules requiring corporations to make far more detailed public disclosures about the compensation of their

\(^7\) Yet another pay practice that diluted the incentive effect of stock-option compensation was option “reloading.” With reload options, once an executive had exercised her options, she would get the same number of new options, struck at the current market price. Of course, reload options created incentives to “ratchet up.” Each time the stock price blipped upward, executives would exercise their options and then receive new options struck at the new market price.

\(^8\) See, e.g., Rakesh Khurana, Searching for a Corporate Savior: The Irrational Quest for Charismatic CEOs (2002).
top five corporate officers. Three elements were particularly noteworthy. First, companies had to disclose, in a standardized Summary Compensation Table, the annual compensation (salary, bonus, etc.), long-term compensation (restricted stock awards, option awards, etc.), and all other compensation for the top five employees in the company. Second, the 1993 reforms required a narrative description of all employment contracts with top executives, and disclosure of a Compensation Committee report explaining the committee’s compensation decisions. Finally, the reforms required a graph showing the company’s cumulative shareholder returns for the previous five years, along with a broad-based market index and a peer-group index for the same period.

The net effect of these reforms was increased transparency, the implicit goal of which was (presumably) to “shame” corporations into “reasonable” compensation for their top executives. However, rather than keeping CEO compensation down, the SEC’s disclosure requirement seemed to have had the opposite effect, due to the particular way in which CEO pay is set. Typically, the compensation committee of the board will hire a compensation consultant, who will then identify a set of comparable companies. Beginning in 1993, the consultant would have excellent visibility as to the pay of the top executives at these comparable companies. Using this information, the consultant would issue a report to the compensation committee. Typically, compensation committees would want to pay their CEO at roughly the 75th percentile among comparable companies, reflecting the fact that their CEO is (of course) above average. But if all boards are aiming to pay their CEO at the 75th percentile, then we get a general ratcheting up of CEO pay levels along the lines of what is documented in the chart above. The 1993 disclosure requirement fueled this trend by creating greater visibility on the pay of (arguably) comparable CEOs.

In the cynic’s view, then, heavily conflicted compensation committee directors conspired with compensation consultants and their unwitting accomplice, the SEC, to send CEO pay into an upward spiral for much of the next two decades. CEO pay, which had previously received little attention from everyday Americans, became front-page news. In July 2001, Fortune magazine, led with a cover story entitled “Inside the Great CEO Pay Heist” and added for good measure, “Why the madness won’t stop.” In October 2003, the cover story in The Economist lamented, “Where’s the stick? The problem with lavish executive pay.” According to their editors, “CEOs are selected for their cleverness and determination, and they have directed these qualities at boosting their own pay. The more the public spotlight is thrown on one aspect of bosses’ remuneration, it seems, the more it rises elsewhere.”

In 2006, the SEC, under the leadership of Chairman Christopher Cox, returned to the issue of executive compensation. As in 1993, the focus of the 2006 reforms was increased disclosure of executive compensation. The new SEC rule requires a single number that captures all compensation for each of the top executives, as well as improved disclosures on retirement payouts, perquisites, directors’ pay, and related-party transactions. Chairman Cox argued that these changes would further improve transparency for investors and the public at large. On one hand, increased transparency might pressure directors to keep all forms of compensation “reasonable.” On the other hand, increased
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transparency might accelerate compensation growth rates even further, or push compensation into other, even more difficult to detect, forms.

The financial crisis of 2008, again, threw the spotlight on executive pay. Some commentators argued that the massive stock-option grants held by top executives at large U.S. financial institutions—that is, precisely the same device that pay experts applauded two decades earlier—fueled the financial crisis by encouraging executives to make excessively risky investments. If these investments paid off, the stock price would go up and managers would become staggeringly wealthy. If the investments didn’t pay off and the stock price went down, executives’ options would go out of the money but the shareholders and creditors, not the executives, would suffer the full downside consequences. (If this argument sounds vaguely familiar, consider the Credit Lyonnais excerpt reproduced in Chapter 4.) In this analysis, the highly leveraged investments that seemed excessively risky in hindsight were the inevitable consequences of sophisticated managers responding rationally to their compensation system.

In addition, some pointed out that senior bank executives took enormous amounts of money “off the table” in the form of salary and bonus before the financial crisis hit. For example, the top executive teams at Bear Stearns and Lehman Brothers (two victims of the financial crisis) derived cash flows of approximately $1.4 billion and $1 billion, respectively, from cash bonuses and stock sales during the period 2000-2008. With this kind of cash in hand, executives at these two firms might have been more willing to “roll the dice” with their firms’ assets. A lurking question, then—one that will never be answered definitively—is whether the compensation systems at these two banks were at least partly responsible for their failure.

The U.S. Congress, of course, does not need to determine root causes in order to respond to the perceived problem of executive pay. After each of the two major meltdowns of the past decade, Congress enacted significant reforms in this arena. In 2002, Congress passed the Sarbanes-Oxley Act, which among other things responded to several instances from the early 2000s in which top executives would reap large financial awards and later restate financials. Section 304 of the Act provides that if a company must restate its financials as a result of executive misconduct, the CEO and CFO must pay back to the company any bonuses, other incentive-based or equity-based pay, and/or trading profits realized in the twelve months after the incorrect financial information was publicly disclosed. In 2010, §954 of the Dodd-Frank Wall Street Reform and Consumer Protection Act added a more stringent clawback requirement. Publicly listed companies that restate their financial statements due to material noncompliance with reporting requirements must seek repayment from any current or former executive officer of any incentive-based compensation (including stock options) paid during the three-year period prior to the restatement date.

The clawback provisions in Dodd-Frank go beyond the provisions in the Sarbanes-Oxley Act in three important ways. First, the look-back period

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A "Yes" in Say on Pay
Wall Street Journal (July 8, 2011)

Congress gave shareholders a new "say on pay" over executive compensation. And the returns are in: At 98.5% of companies, the answer was yes.

Of 2,532 companies reporting, shareholders at 39 of them rejected executive pay plans. The votes, which were put into place by the Dodd-Frank financial overhaul, are non-binding, so companies don't have to change anything even if shareholders disapprove. HP and Stanley Black & Decker [two companies that lost Say on Pay votes] declined to comment...

[Despite their non-binding nature], pay watchers say the votes have had an impact. Some companies secured passage by modifying their pay plans at the last minute; others had to lobby hard against criticism.

Shareholders have seized on failed votes as ammunition for lawsuits. They sued boards of directors at a handful of companies whose votes failed, including Jacobs Engineering Group Inc. and Umpqua Holdings Corp.

The suits generally cite the vote rejection as evidence that directors ignored shareholders' wishes for more modest pay packages, breaching their fiduciary duty to investors...

is extended from twelve months to three years. Second, clawback coverage is extended from solely the CEO and CFO to any current or former executive. Third, the Act's provision eliminates the requirement of misconduct to trigger clawbacks. Under the new provision, incentive-based compensation can be recovered in the event of accounting restatements due to a company's material non-compliance with financial reporting requirements, regardless of whether the restatements resulted from executive misconduct.

The Dodd-Frank Act also requires a non-binding shareholder advisory vote at least once every three years to approve the compensation of public companies' named executive officers (a so-called "Say on Pay" vote). Further, the Act requires a non-binding advisory vote to determine whether Say on Pay votes should occur every one, two, or three years. The new requirement mirrors the rule that has governed British companies since 2002. Sweden and Australia have also followed the U.K. advisory-vote approach, while the Netherlands and Norway have gone further on Say on Pay, providing shareholders with a binding annual vote on top executive compensation. In 2011, in the first year of Say on Pay votes in the United States, the vast majority of companies got approval for their pay packages, but those that did not suffered negative consequences even though the votes were merely advisory (see sidebar). In addition, and perhaps unsurprisingly, shareholders at the vast majority of U.S. companies voted themselves an annual Say on Pay vote.

Section 954 of the Dodd-Frank Act regulates "golden parachute" compensation through related disclosure and shareholder approval provisions. Any solicitation of shareholder votes to approve an acquisition, merger, consoli-
8.4 Are U.S. CEOs Paid Too Much?

The period from 1993 to 2006 was among the best of economic times in the United States. Price stability, decreasing unemployment and capital costs, and increasing domestic production, investment, and technological innovation sustained extraordinarily high growth rates. From this perspective, it is not surprising that the total compensation for CEOs of Fortune 500 companies grew rapidly, but the question, of course, remains as to whether the growth in corporate wealth provides a complete explanation for the growth of CEO pay.

On one hand, Professors Lucian Bebchuk and Yaniv Grinstein calculate that share price performance, industry effects, and increases in firm size can explain only half of the overall growth in CEO pay during the period 1993 to 2003.\(^\text{12}\) Bebchuk and Grinstein further report that aggregate compensation for the top five managers increased from 5 percent of corporate profits in 1993 to approximately 10 percent in 2003.\(^\text{13}\) In a similar vein, Professor Kevin J. Murphy calculates that in 1970, the average pay of a CEO in a public company was approximately 25 times greater than the average worker’s pay, but by 1996, that ratio had increased to over 200 times.\(^\text{14}\) Another more recent study finds that CEO pay in the United States grew in real terms by 45 percent between 2003 and 2007, compared with a real pay increase of 15 percent in the case of the average executive, and 2.7 percent for the average American worker.\(^\text{15}\) These findings would suggest a fundamental change in the underlying mechanisms that set top executive pay in the 1990s and 2000s.

On the other hand, Professors Xavier Gabaix and Augustin Landier of NYU’s Stern School of Business developed a model of CEO pay predicting that

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13. Id.
pay should increase one-to-one with the average market capitalization of large firms in the economy. \textsuperscript{15} The intuition is that talented CEOs are a relatively rare and valuable resource, so this resource is worth more when it can be deployed to affect larger aggregations of assets. Gabaix and Landier find that the roughly six-fold increase in market capitalization of large U.S. companies between 1980 and 2003 can fully explain the roughly six-fold increase in CEO pay during the same period.

Whatever the explanation for the growth of CEO pay, it is clear that the astonishing payments made to certain CEOs by their companies are a frequent source of concern. In addition, shareholder advocates attack many common features of top executive compensation, including its overall level (for being too high), its form (for not sufficiently punishing failure), the procedures used for setting compensation (for being insufficiently disinterested), and the common sweeteners in compensation contracts, such as "golden parachutes," that reward executives for standing aside gracefully in the sale of their companies.

It is difficult to determine whether any particular CEO, or even CEOs as a class, receives excessive pay, partly because it is difficult to estimate the market price for unique executive talent. Senior officers are not fungible. Many suspect that the process that sets their compensation does not produce a true reading of the market, but suspicion is a frail basis for judicial review. Moreover, the recent period of high growth in CEO compensation has also been a time of substantially greater CEO turnover, much of it forced. \textsuperscript{16} CEOs get fired more often today than before, and economic theory suggests that increases in the riskiness of future payments will reduce the present value of the flow of funds. Thus, we would expect CEO compensation to rise in response to reduced job security.

So, is CEO pay too high? Whichever side of that debate one takes, two things remain clear. First, there are some cases of abusive CEO pay. Second, the general level of CEO pay is such that even if it were in fact efficient, it creates social costs in the form of resentment, jealousy, and anger. In an age of global competition, shop floor wages are depressed by low-cost manufacturing options offered in developing regions of the world. This constraint is arguably less pertinent in the case of the more rare talent to manage large organizations. So a growing divide between the top and the average workers, even if one may understand its drivers, creates political challenges for corporate boards.

LUCIAN BECHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: OVERVIEW OF THE ISSUES
30 J. Corp. L. 647 (2005)

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

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

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

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

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

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

BENGST HOLMSTROM, PAY WITHOUT PERFORMANCE AND THE MANAGERIAL POWER HYPOTHESIS: A COMMENT
30 J. Corp. L. 503 (2005)

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

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

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

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

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

8.5 Judicial Review of Compensation

8.5.1. The Law of Director and Officer Compensation

It might be thought that judicial review would be another important constraint on executive compensation, perhaps as a backstop when other mechanisms fail. That is, in the rare situation where the ostensibly independent compensation committee does not do its job, the disclosure requirements do not appropriately “shame” the CEO or the board, and (more recently) a negative “Say on Pay” vote does not result in appropriate change, shareholder-plaintiffs could successfully challenge the level of executive pay in court. Whatever normative appeal this framework might have, it is not the approach that the Delaware courts have taken. Instead, Delaware has largely “left the field” in the realm of executive pay through the application of the “waste” standard to executive pay challenges. Although specific definitions vary, waste is thought to mean the absence of any consideration”—an exceedingly deferential standard of review.

The courts’ approach might reflect the enormous difficulty in assessing executive pay. Or, it might reflect the courts’ uncaseessness in second-guessing the pay decisions made by a well-informed and unconflicted board. Whatever the motivation, the courts’ approach was severely tested by the compensation practices at large financial institutions during the financial crisis. Newspapers were filled with accounts of top professionals getting paid astronomical sums, while taxpayers funded bailouts of their banks. Famed investment banking house Goldman Sachs was particularly notorious in this regard (see sidebar), and plaintiff-shareholders challenged Goldman’s pay practices in Delaware Chancery Court. The opinion, excerpted below, is unremarkable in its outcome, but perhaps illustrates the unwillingness of the Delaware courts to bend to popular sentiment on executive pay.

QUESTION

Under indemnification statutes such as DGCL §145, when an officer or director is sued for any action she arguably took in furtherance of her corporate duties, the corporation may "advance" reasonable defense costs even before it is determined that the expenses are properly indemnifiable under the corporate bylaws. Is this common practice made unlawful under SOX §402? Are there arguments under which it may continue?

8.5.3 The Disney Decision

In the aftermath of Enron and the resulting public focus on perceived deficiencies in corporate controls, the judicial urge to correct perceived governance excesses became irresistible. Few areas of corporate governance had drawn more attention during the booming 1990s than executive compensation. Therefore, it is perhaps not surprising that the next area of corporate governance to witness erosion of the business judgment rule was executive compensation. The case in which this development burst forth arose from astonishing facts involving a payment of compensation valued at approximately $140 million to Michael Ovitz upon his termination by the Walt Disney Company after a bit more than one year of service.

The story begins with the accidental death of Frank Wells in 1994. Wells had been number two to Disney’s CEO Michael Eisner for ten years, and together the management team had been highly successful. There were no acceptable inside candidates for Wells’s job and for the time being Eisner assumed these duties. About a year later, Eisner had a health scare, and the board insisted that succession planning be addressed. Michael Ovitz had started a talent agency in 1974 with Ron Meyer and others called Creative Artists Agency (CAA). He represented many of the biggest stars in Hollywood and was an effective negotiator. Eisner and Ovitz had been personal friends for twenty-five years, and Eisner had approached Ovitz several times (unsuccessfully) to have him join Disney’s management team.

In July 1995, after Meyer left CAA to join MCA, Eisner sensed that the time might be ripe to approach Ovitz again. Ovitz’s income at this time was $20-$25 million per year, and in the ensuing negotiations with Eisner and Disney, he insisted on substantial “downside protection” in order to give up his 55 percent interest in CAA. Eisner and Irwin Russell, chairman of Disney’s compensation committee, led the negotiations for Disney. Russell recruited Grief Crystal, an executive compensation consultant, and Raymond Watson, a former Disney board chairman, to help evaluate the financial terms of Ovitz’s employment agreement. In August 1995, Ovitz accepted the job as President of Walt Disney, and joined the Disney board. Disney’s stock price rose 4.4 percent on the day of the announcement, increasing Disney’s market capitalization by more than $1 billion.

It rapidly became clear that Ovitz was a poor fit for Disney. In November 1996, Eisner asked Sanford Litvack, Disney’s general counsel, whether Ovitz...

21. For a fascinating exposition of this point, see James B. Stewart. DisneyWar (2004).
8.5 Judicial Review of Compensation

could be fired “for cause,” which would have avoided the “non-fault termination” (“NFT”) payments that were built in to Ovitz’s employment agreement. After studying the facts and consulting with others in Disney’s legal department, Litvak concluded that Ovitz could not be fired for cause, though Litvak did not personally conduct any legal research or request an outside opinion on the issue. In December 1996, the Disney board fired Ovitz “without cause,” thus triggering approximately $38 million in cash severance payments and accelerated vesting of options under Ovitz’s employment agreement. When all the dust had settled, Ovitz had received approximately $140 million in compensation for fifteen months of service as President of Disney. In both the hiring and firing of Michael Ovitz, the extensive factual record made clear that the directors other than Eisner and, secondarily, Russell were only marginally involved in the decision-making processes.

Shareholder plaintiffs brought suit on behalf of the corporation claiming, among other things, that the Disney directors breached their duty of care in approving Ovitz’s employment agreement, and that the severance payment to Ovitz constituted waste. The Disney charter contained a §102(b)(7) waiver, which meant that the plaintiffs had to assert that the board had not acted in “good faith.” In October 1998, the Delaware Chancery Court dismissed the complaint on the grounds that the board was made up of a majority of independent directors who had no interest in the transaction. Chancellor Chandler wrote: “Just as the 85,000-ton cruise ships Disney Magic and Disney Wonder are forced by science to obey the same laws of buoyancy as Disneyland’s significantly smaller Jungle Cruise ships, so is a corporate board’s extraordinary decision to award a $140 million severance package governed by the same corporate law principles as its everyday decision to authorize a loan.” In re Walt Disney Co. Derivative Litigation, 731 A.2d 342, 351 (Del. Ch. 1998). On appeal, the Supreme Court of Delaware reversed in part and directed that plaintiff be given an opportunity to replead. Breitn v. Eisner, 746 A.2d 244 (Del. 2000). When reviewing the repleaded complaint on remand, the Chancellor sustained the complaint:

These [alleged] facts, if true, do more than portray directors who, in a negligent or grossly negligent manner, merely failed to inform themselves or to deliberate adequately about an issue of material importance to their corporation. Instead, the facts alleged in the new complaint suggest that the defendant directors consciously and intentionally disregarded their responsibilities, adopting a “we don’t care about the risks” attitude concerning a material corporate decision. Knowing or deliberate indifference by a director to his or her duty to act faithfully and with appropriate care is conduct, in my opinion, that may not have been taken honestly and in good faith to advance the best interests of the company. Put differently, all of the alleged facts, if true, imply that the defendant directors knew that they were making material decisions without adequate information and without adequate deliberation, and that they simply did not care if the decisions caused the corporation and its stockholders to suffer injury or loss. Viewed in this light, plaintiffs’ new complaint sufficiently alleges a breach of the directors’ obligation to act honestly and in good faith in the corporation’s best interests for a Court to conclude, if the facts are true, that the defendant directors’ conduct fell outside the protection of the business judgment rule.
Where a director consciously ignores his or her duties to the corporation, thereby causing economic injury to its stockholders, the director's actions are either "not in good faith" or "involve intentional misconduct" (citing §102(b)(7)(D)). Thus, plaintiffs' allegations support claims that fall outside the liability waiver provided under Disney's certificate of incorporation.22

The trial consumed thirty-seven days of testimony. On August 9, 2005, Chancellor Chandler issued a 174-page decision exhaustively reviewing the testimony and concluding that plaintiffs bore the burden of proof on their claims against all defendants, including Ovitz, and that they had failed to carry that burden.

IN RE THE WALT DISNEY COMPANY
DERIVATIVE LITIGATION
2005 WL 2056651 (Del. Ch. 2005)

CHANDLER, C.:

... Stripped of the presumptions in their favor that have carried them to trial, plaintiffs must now rely on the evidence presented at trial to demonstrate by a preponderance of the evidence that the defendants violated their fiduciary duties and/or committed waste. More specifically, in the area of director action, plaintiffs must prove by a preponderance of the evidence that the presumption of the business judgment rule does not apply either because the directors breached their fiduciary duties, acted in bad faith or that the directors made an "unintelligent or unadvised judgment," by failing to inform themselves of all material information reasonably available to them before making a business decision.

If plaintiffs cannot rebut the presumption of the business judgment rule, the defendants will prevail. If plaintiffs succeed in rebutting the presumption of the business judgment rule, the burden then shifts to the defendants to prove by a preponderance of the evidence that the challenged transactions were entirely fair to the corporation.

As it relates to director inaction, plaintiffs will prevail upon proving by a preponderance of the evidence that the defendants breached their fiduciary duties by not acting. In order to invoke the protections of the provision in the Company's certificate of incorporation authorized by 8 Del. C. §102(b)(7), the defendants must prove by a preponderance of the evidence that they are entitled to the protections of that provision.

THE OLD BOARD'S DECISION TO HIRE OVITZ AND THE COMPENSATION COMMITTEE'S APPROVAL OF THE OEA [ORIGINAL EMPLOYMENT AGREEMENT] WAS NOT GROSSLY NEGLIGENT AND NOT IN BAD FAITH

The members of the "Old Board" (Eisner, Bollenbach, Litvack, Russell, Roy Disney, Gold, Nunn, Poitier, Stern, Walker, Watson, Wilson, Bowers, Lozano

and Mitchell) were required to comply with their fiduciary duties on behalf of the Company's shareholders while taking the actions that brought Ovitz to the Company. For the future, many lessons of what not to do can be learned from defendants' conduct here. Nevertheless, I conclude that the only reasonable application of the law to the facts as I have found them, is that the defendants did not act in bad faith, and were at most ordinarily negligent, in connection with the hiring of Ovitz and the approval of the OEA. In accordance with the business judgment rule (because, as it turns out, business judgment was exercised), ordinary negligence is insufficient to constitute a violation of the fiduciary duty of care. I shall elaborate upon this conclusion as to each defendant.

EISNER

Eisner was clearly the person most heavily involved in bringing Ovitz to the Company and negotiating the OEA. He was a long-time friend of Ovitz and the instigator and mastermind behind the machinations that resulted in Ovitz's hiring and the concomitant approval of the OEA. In that aspect, Eisner is the most culpable of the defendants. He was pulling the strings; he knew what was going on. On the other hand, at least as the duty of care is typically defined in the context of a business judgment (such as a decision to select and hire a corporate president), all of the defendants, he was certainly the most informed of all reasonably available material information, making him the least culpable in that regard.

As a general rule, a CEO has no obligation to continuously inform the board of his actions as CEO, or to receive prior authorization for those actions. Nevertheless, a reasonably prudent CEO (that is to say, a reasonably prudent CEO with a board willing to think for itself and assert itself against the CEO when necessary) would not have acted in as unilateral a manner as did Eisner when essentially committing the corporation to hire a second-in-command, appoint that person to the board, and provide him with one of the largest and richest employment contracts ever enjoyed by a non-CEO. I write, "essentially committing," because although I conclude that legally Ovitz's hiring was not a "done deal" as of the August 14 OLA (Original Letter Agreement), it was clear to Eisner, Ovitz, and the directors who were informed, that as a practical matter, it certainly was a "done deal."

Norwithstanding the foregoing, Eisner's actions in connection with Ovitz's hiring should not serve as a model for fellow executives and fiduciaries to follow. His lapses were many. He failed to keep the board as informed as he should have. He stretched the outer boundaries of his authority as CEO by acting without specific board direction or involvement. He prematurely issued a press release that placed significant pressure on the board to accept Ovitz and approve his compensation package in accordance with the press release. To my mind, these actions fall far short of what shareholders expect and demand from those entrusted with a fiduciary position. Eisner's failure to better involve the board in the process of Ovitz's hiring, usurping that role for himself, although not in violation of law, does not comport with how fiduciaries of Delaware corporations are expected to act.
Despite all of the legitimate criticisms that may be leveled at Eisner, especially at having enthroned himself as the omnipotent and infallible monarch of his personal Magic Kingdom, I nonetheless conclude, after carefully considering and weighing all the evidence, that Eisner’s actions were taken in good faith. That is, Eisner’s actions were taken with the subjective belief that those actions were in the best interests of the Company — he believed that his taking charge and acting swiftly and decisively to hire Ovitz would serve the best interests of the Company notwithstanding the high cost of Ovitz’s hiring and notwithstanding that two experienced executives who had arguably been passed over for the position (Litvack and Bollenbach) were not completely supportive.

[The court then examined the actions of all of the other Disney directors individually, and reached the same conclusion with respect to each.]

**EISNER AND LITVACK DID NOT ACT IN BAD FAITH IN CONNECTION WITH OVITZ’S TERMINATION, AND THE REMAINDER OF THE NEW BOARD HAD NO DUTIES IN CONNECTION THEREWITH**

The New Board was likewise charged with complying with their fiduciary duties in connection with any actions taken, or required to be taken, in connection with Ovitz’s termination. The key question here becomes whether the board was under a duty to act in connection with Ovitz’s termination, because if the directors were under no duty to act, then they could not have acted in bad faith by not acting, nor would they have failed to inform themselves of all material information reasonably available before making a decision, because no decision was required to be made. Furthermore, the actions taken by the Company’s officers (namely Eisner and Litvack) in connection with Ovitz’s termination must be viewed through the lens of whether the board was under a duty to act. If the board was under no such duty, then the officers are justified in acting alone. If the board was under a duty to act and the officers improperly usurped that authority, the analysis would obviously be different.

**THE NEW BOARD WAS NOT UNDER A DUTY TO ACT**

[Having reviewed Disney’s governing documents,] I come to the following conclusions: 1) the board of directors has the sole power to elect the officers of the Company; 2) the board of directors has the sole power to determine the “duties” of the officers of the Company (either through board resolutions or bylaws); 3) the Chairman/CEO has “general and active management, direction, and supervision over the business of the Corporation and over its officers,” and that such management, direction and supervision is subject to the control of the board of directors; 4) the Chairman/CEO has the power to manage, direct and supervise the lesser officers and employees of the Company; 5) the board has the *right*, but not the *duty* to remove the officers of
8.5 Judicial Review of Compensation

the Company with or without cause, and that right is non-exclusive; and 6) because that right is non-exclusive, and because the Chairman/CEO is affirmatively charged with the management, direction and supervision of the officers of the Company, together with the powers and duties incident to the office of chief executive, the Chairman/CEO, subject to the control of the board of directors, also possesses the right to remove the inferior officers and employees of the corporation.

The New Board unanimously believed that Eisner, as Chairman and CEO, possessed the power to terminate Ovitz without board approval or intervention. Nonetheless, the board was informed of and supported Eisner’s decision. The board’s simultaneous power to terminate Ovitz, reserved to the board by the certificate of incorporation, did not divest Eisner of the authority to do so, or vice-versa. Eisner used that authority, and terminated Ovitz — a decision, coupled with the decision to honor the OEA, that resulted in the Company’s obligation to pay the NFT. Because Eisner unilaterally terminated Ovitz, as was his right, the New Board was not required to act in connection with Ovitz’s termination.

Therefore, the fact that no formal board action was taken with respect to Ovitz’s termination is of no import. For these reasons, the members of the New Board (other than Eisner and Litvak, who will be discussed individually below) did not breach their fiduciary duties and did not act in bad faith in connection with Ovitz’s termination and his receipt of the NFT benefits included in the OEA.

EISNER

Having concluded that Eisner alone possessed the authority to terminate Ovitz and grant him the NFT, I turn to whether Eisner acted in accordance with his fiduciary duties and in good faith when he terminated Ovitz. As will be shown hereafter, I conclude that Eisner did not breach his fiduciary duties and did act in good faith in connection with Ovitz’s termination and concomitant receipt of the NFT.

When Eisner hired Ovitz in 1995, he did so with an eye to preparing the Company for the challenges that lay ahead, especially in light of the CapCities/ABC acquisition and the need for a legitimate potential successor to Eisner. To everyone’s regret, including Ovitz, things did not work out as blissfully as anticipated. Eisner was unable to work well with Ovitz, and Eisner refused to let Ovitz work without close and constant supervision. Faced with that situation, Eisner essentially had three options: 1) keep Ovitz as President and continue trying to make things work; 2) keep Ovitz at Disney, but in a role other than President; or 3) terminate Ovitz.

In deciding which route to take, Eisner, consistent with his discretion as CEO, considered keeping Ovitz as the Company’s President an unacceptable solution. Shunting Ovitz to a different role within the Company would have almost certainly entitled Ovitz to the NFT, or at the very least, a costly lawsuit to determine whether Ovitz was so entitled. Eisner would have also rightly questioned whether there was another position within the Company where
Chapter 8. Executive Compensation

Ovitz could be of use. Eisner was then left with the only alternative he considered feasible — termination. Faced with the knowledge that termination was the best alternative and knowing that Ovitz had not performed to the high expectations placed upon him when he was hired, Eisner inquired of Litvak on several occasions as to whether a for-cause termination was possible such that the NFT payment could be avoided, and then relied in good faith on the opinion of the Company’s general counsel. ... In the end, however, he bit the bullet and decided that the best decision would be to terminate Ovitz and pay the NFT.

After reflection on the more than ample record in this case, I conclude that Eisner’s actions in connection with the termination are, for the most part, consistent with what is expected of a faithful fiduciary....

CONCLUSION

For the reasons set forth in the Court’s Opinion of this date, judgment is hereby entered in the above captioned action against plaintiffs and in favor of defendants on all counts. The parties shall bear their own costs. IT IS SO ORDERED.

NOTE ON DISNEY AND THE DIRECTOR’S DUTY OF GOOD FAITH

Plaintiffs appealed once again to the Delaware Supreme Court. In June 2006, the supreme court affirmed.23 Perhaps the most important part of the court’s opinion is not the holding, which was doctrinally unremarkable and widely expected among practitioners and commentators, but rather the guidance that the court provides in dicta on the “duty of good faith.” Writing for the court, Justice Jack Jacobs provided a spectrum of behavior for identifying “bad faith” conduct. On one end of the spectrum, fiduciary conduct that is “motivated by an actual intent to do harm” constitutes “classic, quintessential bad faith.” On the other end of the spectrum, grossly negligent conduct, without any malevolent intent, cannot constitute bad faith. In between lies conduct that involves “intentional dereliction of duty, a conscious disregard for one’s responsibilities.” The court concluded that “such misconduct is properly treated as a non-exculpable, non-indemnifiable violation of the fiduciary duty to act in good faith.” While the court clarified a good deal of ground, in a footnote it left open one of the big questions: “[W]e do not reach or otherwise address the issue of whether the fiduciary duty to act in good faith is a duty that, like the duties of care and loyalty, can serve as an independent basis for imposing liability upon corporate officers and directors.”24

Five months later, in Stone v. Ritter,25 the Delaware Supreme Court answered the question it left open in its Disney decision. First, Stone v. Ritter

23. 906 A.2d 27 (Del. 2006).
24. Id. at 67 n.12.
25. 911 A.2d 562 (Del. 2006).
ingly . . . [d]oes any act in such unreasonable manner as to alarm or disturb another and to provoke a breach of the peace." 720 I.L.L. Comp. Stat. 5/26–1(a)(1) (2006). That Bob Lesner was not also arrested is irrelevant. That the focus of the argument was the tombstones—protected speech—is likewise irrelevant. We have already held that Officer Mason is entitled to qualified immunity to the extent the arrest was related to Jeff Purtell’s exercise of his First Amendment rights. The mounting public argument between Lesner and Purtell supplied probable cause to arrest for disorderly conduct apart from Purtell’s exercise of free speech. Accordingly, there was no Fourth Amendment violation, and summary judgment on this claim was appropriate.

III. Conclusion

In closing, a few words in defense of a saner use of judicial resources. It is unfortunate that this petty neighborhood dispute found its way into federal court, invoking the machinery of a justice system that is admired around the world. The suit was not so wholly without basis in fact or law as to be frivolous, but neither was it worth the inordinate effort it has taken to adjudicate it—on the part of judges, jurors, court staff, and attorneys (all, of course, at public expense). We take this opportunity to remind the bar that sound and responsible legal representation includes counseling as well as advocacy. The wiser course would have been to counsel the plaintiffs against filing such a trivial lawsuit. Freedom of speech encompasses “the freedom to speak foolishly and without moderation,” Cohen, 403 U.S. at 26, 91 S.Ct. 1780 (quoting Baumgartner v. United States, 322 U.S. 665, 674, 64 S.Ct. 1240, 88 L.Ed. 1525 (1944)), but it does not follow that every nominal violation of that right is—or should be—compensable. See Brandt v. Bd. of Educ. of City of Chi., 480 F.3d 460, 465 (7th Cir.2007) ("[D]e minimis non curat lex (the law doesn’t concern itself with trifles) is a doctrine applicable to constitutional as to other cases," and an award of nominal damages “presupposes a violation of sufficient gravity to merit a judgment, even if significant damages cannot be proved."). Not every constitutional grievance deserves an airing in court. Lawsuits like this one cast the legal profession in a bad light and contribute to the impression that Americans are an overlawyered and excessively litigious people.

AFFIRMED.

Jerry N. JONES, Mary F. Jones, and Arline Winerman, Plaintiffs–Appellants,

v.

HARRIS ASSOCIATES L.P.,
Defendant–Appellee.

No. 07–1624.

United States Court of Appeals,
Seventh Circuit.


Decided May 19, 2008.

Background: Owners of shares in mutual funds brought action against investment advisor under Investment Company Act alleging that advisor’s compensation was too high. The United States District Court for the Northern District of Illinois, Charles P. Kocoras, Senior District Judge, 2007 WL 627640, granted summary judgment for advisor. Owners appealed.
voluntary choice ex ante with the benefit of adequate information.

8. **Attorney and Client C=106, 114, 143**

A lawyer cannot deceive his client or take strategic advantage of the dependence that develops once representation begins, but hard bargaining and seemingly steep compensation rates are lawful.

James C. Bradley, Richardson, Patrick, Westbrook & Brickman, Charleston, SC, Ernest Young (argued), Austin, TX, for Plaintiffs–Appellants.

Gordon B. Nash, Jr., Drinker, Biddle & Reath, Chicago, IL, John D. Donovan, Jr. (argued), Brian R. Blais, Ropes & Gray, Boston, MA, for Defendant–Appellee.

Before EASTERBROOK, Chief Judge, and KANNE and EVANS, Circuit Judges.

EASTERBROOK, Chief Judge.

Harris Associates advises the Oakmark complex of mutual funds. These open-end funds (an open-end fund is one that buys back its shares at current asset value) have grown in recent years because their net returns have exceeded the market average, and the investment adviser’s compensation has grown apace. Plaintiffs, who own shares in several of the Oakmark funds, contend that the fees are too high and thus violate § 36(b) of the Investment Company Act of 1940, 15 U.S.C. § 80a–35(b), a provision added in 1970. The district court concluded that Harris Associates had not violated the Act and granted summary judgment in its favor. 2007 WL 627640, 2007 U.S. Dist. LEXIS 13352 (N.D.Ill. Feb. 27, 2007).

[1, 2] Plaintiffs rely on several sections of the Act in addition to § 36(b), and we can make short work of these. The Act requires at least 40% of a mutual fund’s trustees to be disinterested in the adviser, see 15 U.S.C. § 80a–10(a), and obliges the fund to reveal the financial links between its trustees and the adviser, see 15 U.S.C. § 80a–33(b). Compensation for the adviser is controlled by a majority of the disinterested trustees. 15 U.S.C. § 80a–15(c). Plaintiffs say that the Oakmark funds have violated all of these rules. Because none of the funds is a party to this suit, an order directing the funds to comply is not available as relief. Plaintiffs say that the court could require Harris to return the compensation it has received, but such a penalty would be disproportionate to the wrong. That’s not the only problem: although § 36(b) creates a private right of action, the other sections we have mentioned do not. We need not decide whether a private right of action should be implied, see Alexander v. Sandoval, 532 U.S. 275, 121 S.Ct. 1511, 149 L.Ed.2d 517 (2001), or whether a sensible remedy could be devised, as there has been no violation of § 10(a) or § 15(c).

Victor Morgenstern is among the funds’ trustees. Until the end of 2000, when he retired, Morgenstern was a partner of Harris Associates and counted among the funds’ “interested” trustees. Since his retirement, Morgenstern has been treated as a disinterested trustee and has voted at the special meetings that deal with the adviser’s compensation. Plaintiffs insist that Morgenstern does not meet the statutory standards because Harris Associates bought out his partnership with a stream of payments that can be deferred if Harris does not satisfy performance benchmarks in a given year. This makes the payments a form of profit sharing, plaintiffs contend, and because profit-sharing agreements are treated as “securities” under 15 U.S.C. § 80a–2(a)(36), Morgenstern owns securities in Harris Associates and is not dis-
terested. 15 U.S.C. § 80a–2(a)(19)(B)(iii). Moreover, plaintiffs continue, the Oakmark funds did not disclose these facts to the public and so are out of compliance with 15 U.S.C. § 80a–33(b).

Harris Associates contends that payments fixed in amount are not “profit sharing” in the statutory sense just because the time of payment is uncertain. Let us assume (again without deciding) that Morgenstern held a “security” under the Act because he was exposed to the risk of business reverses at his old firm. Failure to disclose Morgenstern’s post-retirement payments from Harris Associates might support an order directing the funds to correct their annual reports and other official disclosure documents but would not justify any relief against Harris Associates. To get anywhere, even with a private right of action, plaintiffs would have to show the sort of violation that knocks out any valid contract between Harris Associates and the funds. Only a violation of the 40%-independence rule or the approval-by-a-majority-of-disinterested-trustees rule could do that. Yet most of the funds' trustees are disinterested even if Morgenstern is treated as interested.

During the time covered by the suit, the funds had nine or ten trustees, at least seven of whom are independent even if we count Morgenstern as interested. That's comfortably over the statutory requirement that 40% of trustees be disinterested. And as the disinterested trustees unanimously approved the contracts with Harris Associates, it makes no difference how Morgenstern is classified. Plaintiffs ask us to suppose that Morgenstern possessed some Svengali-like sway over the other trustees, so that his presence in the room was enough to spoil their decisions. But in 2000 and before, when Morgenstern had been treated as interested, the disinterested trustees met in his absence and approved Harris's compensation. More: although the disinterested directors initially meet separately, the whole board ultimately discusses and votes on the contract. 15 U.S.C. § 80a–15(a)(2). Interested directors are not silenced. So it is impossible to see how Morgenstern’s role from 2001 through 2004 can be treated as poisoning the deliberations.

[3] Now for the main event: plaintiffs' contention that the adviser's fees are excessive. They rely on § 36(b), which provides:

For the purposes of this subsection, the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser. An action may be brought under this subsection by the Commission, or by a security holder of such registered investment company on behalf of such company, against such investment adviser. . . . With respect to any such action the following provisions shall apply:

(1) It shall not be necessary to allege or prove that any defendant engaged in personal misconduct, and the plaintiff shall have the burden of proving a breach of fiduciary duty.

(2) In any such action approval by the board of directors of such investment company of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, and ratification or approval of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, by the shareholders of such investment company,
shall be given such consideration by the court as is deemed appropriate under all the circumstances. . . .

The district court followed Gartenberg v. Merrill Lynch Asset Management, Inc., 694 F.2d 923 (2d Cir. 1982), and concluded that Harris Associates must prevail because its fees are ordinary. Gartenberg articulated two variations on a theme:

[T]he test is essentially whether the fee schedule represents a charge within the range of what would have been negotiated at arm’s-length in the light of all of the surrounding circumstances.

694 F.2d at 928. And

[t]o be guilty of a violation of § 36(b) . . . the adviser-manager must charge a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm’s-length bargaining.

Ibid. Oakmark Fund paid Harris Associates 1% (per year) of the first $2 billion of the fund’s assets, 0.9% of the next $1 billion, 0.8% of the next $2 billion, and 0.75% of anything over $5 billion. The district court’s opinion sets out the fees for the other funds; they are similar. It is undisputed that these fees are roughly the same (in both level and breakpoints) as those that other funds of similar size and investment goals pay their advisers, and that the fee structure is lawful under the Investment Advisers Act. See 15 U.S.C. § 80b–5. The Oakmark funds have grown more than the norm for comparable pools, which implies that Harris Associates has delivered value for money.

Plaintiffs contend that we should not follow Gartenberg, for two principal reasons: first, that the second circuit relies too much on market prices as the benchmark of reasonable fees, which plaintiffs insist is inappropriate because fees are set incestuously rather than by competition; second, that if any market should be used as the benchmark, it is the market for advisory services to unaffiliated institutional clients. The first argument stems from the fact that investment advisers create mutual funds, which they dominate notwithstanding the statutory requirement that 40% of trustees be disinterested. Few mutual funds ever change advisers, and plaintiffs conclude from this that the market for advisers is not competitive.

The second argument rests on the fact that Harris Associates, like many other investment advisers, has institutional clients (such as pension funds) that pay less. For a client with investment goals similar to Oakmark Fund, Harris Associates charges 0.75% of the first $15 million under management and 0.35% of the amount over $500 million, with intermediate breakpoints. Plaintiffs maintain that a fiduciary may charge its controlled clients no more than its independent clients.

Like the plaintiffs, the second circuit in Gartenberg expressed some skepticism of competition’s power to constrain investment advisers’ fees.

Competition between [mutual] funds for shareholder business does not support an inference that competition must therefore also exist between adviser-managers for fund business. The former may be vigorous even though the latter is virtually non-existent. Each is governed by different forces.

694 F.2d at 929. The second circuit did not explain why this is so, however. It was content to rely on the observation that mutual funds rarely advertise the level of their management fees, as distinct from the funds’ total expenses as a percentage of assets (a widely publicized benchmark).

Holding costs down is vital in competition, when investors are seeking maximum
return net of expenses—and as management fees are a substantial component of administrative costs, mutual funds have a powerful reason to keep them low unless higher fees are associated with higher return on investment. A difference of 0.1% per annum in total administrative expenses adds up by compounding over time and is enough to induce many investors to change mutual funds. That mutual funds are “captives” of investment advisers does not curtail this competition. An adviser can’t make money from its captive fund if high fees drive investors away.

So just as plaintiffs are skeptical of Gartenberg because it relies too heavily on markets, we are skeptical about Gartenberg because it relies too little on markets. And this is not the first time we have suggested that Gartenberg is wanting. See Green v. Nuveen Advisory Corp., 295 F.3d 738, 743 n. 8 (7th Cir.2002). Two courts of appeals (in addition to the second circuit) have addressed claims against the advisers of open-end mutual funds. One circuit has followed Gartenberg. See Migdal v. Rowe Price–Fleming International, Inc., 248 F.3d 321 (4th Cir.2001). The other has concluded that adherence to the statutory procedures, rather than the level of price, is the right way to understand the “fiduciary” obligation created by § 36(b). See Green v. Fund Asset Management, L.P., 286 F.3d 682 (3d Cir.2002). Our own Green opinion, though it dealt with the obligations of advisers to closed-end funds, indicated sympathy for the third circuit’s position.

[4] Having had another chance to study this question, we now disapprove the Gartenberg approach. A fiduciary duty differs from rate regulation. A fiduciary must make full disclosure and play no tricks but is not subject to a cap on compensation. The trustees (and in the end investors, who vote with their feet and dollars), rather than a judge or jury, determine how much advisory services are worth.

[5] Section 36(b) does not say that fees must be “reasonable” in relation to a judicially created standard. It says instead that the adviser has a fiduciary duty. That is a familiar word; to use it is to summon up the law of trusts. Cf. Firestone Tire & Rubber Co. v. Bruch, 489 U.S. 101, 109 S.Ct. 948, 103 L.Ed.2d 80 (1989). And the rule in trust law is straightforward: A trustee owes an obligation of candor in negotiation, and honesty in performance, but may negotiate in his own interest and accept what the settlor or governance institution agrees to pay. Restatement (Second) of Trusts § 242 & comment f. When the trust instrument is silent about compensation, the trustee may petition a court for an award, and then the court will ask what is “reasonable”; but when the settlor or the persons charged with the trust’s administration make a decision, it is conclusive. John H. Langbein, The Contractarian Basis of the Law of Trusts, 105 Yale L.J. 625 (1995). It is possible to imagine compensation so unusual that a court will infer that deceit must have occurred, or that the persons responsible for decision have abdicated—for example, if a university’s board of trustees decides to pay the president $50 million a year, when no other president of a comparable institution receives more than $2 million—but no court would inquire whether a salary normal among similar institutions is excessive.

Things work the same way for business corporations, which though not trusts are managed by persons who owe fiduciary duties of loyalty to investors. This does not prevent them from demanding substantial compensation and bargaining hard to get it. Publicly traded corporations use the same basic procedures as
mutual funds: a committee of independent directors sets the top managers’ compensation. No court has held that this procedure implies judicial review for “reasonableness” of the resulting salary, bonus, and stock options. These are constrained by competition in several markets—firms that pay too much to managers have trouble raising money, because net profits available for distribution to investors are lower, and these firms also suffer in product markets because they must charge more and consumers turn elsewhere. Competitive processes are imperfect but remain superior to a “just price” system administered by the judiciary. However weak competition may be at weeding out errors, the judicial process is worse—for judges can’t be turned out of office or have their salaries cut if they display poor business judgment.

[6–8] Lawyers have fiduciary duties to their clients but are free to negotiate for high hourly wages or compensation from any judgment. Rates over $500 an hour and contingent fees exceeding a third of any recovery are common. The existence of the fiduciary duty does not imply judicial review for reasonableness; the question a court will ask, if the fee is contested, is whether the client made a voluntary choice ex ante with the benefit of adequate information. Competition rather than litigation determines the fee—and, when judges must set fees, they try to follow the market rather than demand that attorneys’ compensation conform to the judges’ preferences. See, e.g., In re Synthroid Marketing Litigation, 325 F.3d 974 (7th Cir. 2003); In re Continental Illinois Securities Litigation, 962 F.2d 566 (7th Cir. 1992). A lawyer cannot deceive his client or take strategic advantage of the dependence that develops once representation begins, but hard bargaining and seemingly steep rates are lawful.

The list could be extended, but the point has been made. Judicial price-setting does not accompany fiduciary duties. Section 36(b) does not call for a departure from this norm. Plaintiffs ask us to look beyond the statute’s text to its legislative history, but that history, which Gartenberg explores, is like many legislative histories in containing expressions that seem to support every possible position. Some members of Congress equated fiduciary duty with review for reasonableness; others did not (language that would have authorized review of rates for reasonableness was voted down); the Senate committee report disclaimed any link between fiduciary duty and reasonableness of fees. See 694 F.2d at 928.

Statements made during the debates between 1968 and 1970 rest on beliefs about the structure of the mutual-fund market at the time, and plaintiffs say that because many members of Congress deemed competition inadequate (and regulation essential) in 1970, we must act as if competition remains weak today. Why? Congress did not enact its members’ beliefs; it enacted a text. A text authorizing the SEC or the judiciary to set rates would be binding no matter how market conditions change. Section 36(b) does not create a rate-regulation mechanism, and plaintiffs’ proposal to create such a mechanism in 2008 cannot be justified by suppositions about the market conditions of 1970. A lot has happened in the last 38 years.

Today thousands of mutual funds compete. The pages of the Wall Street Journal teem with listings. People can search for and trade funds over the Internet, with negligible transactions costs. “At the end of World War II, there were 73 mutual funds registered with the Securities and Exchange Commission holding $1.2 billion in assets. By the end of 2002, over 8,000 mutual funds held more than $6 trillion in
such as failing to analyze the § 3553(a) factors or failing to adequately explain the chosen sentence. *United States v. Gordon*, 513 F.3d 659, 666 (7th Cir. 2008) (citing *Gall*, 128 S.Ct. at 597). The district court need not address each § 3553(a) factor in checklist fashion, explicitly articulating its conclusion for each factor; rather, the court must simply give an adequate statement of reasons, consistent with § 3553(a), for believing the sentence it selects is appropriate. *Shannon*, 518 F.3d at 496.

[11] In sentencing Chavez at the bottom of the 108–135 month advisory guideline range, the district court sufficiently analyzed the § 3553(a) factors and explained the reasons for Chavez’s sentence, including a consideration of the seriousness of the offense. See § 3553(a)(1) and (2)(A). While the district court did not address each § 3553(a) factor, it was not required to do so. Chavez argues that the court did not address his pleas for leniency, including the negative effects that deportation would have on his family. On the contrary, the district court directly addressed this issue, noting:

The sentence will be punishment, but the deportation will be even greater punishment given the number of family members that you have in the United States. I wish you’d thought of that before you got involved in this criminal activity. Unfortunately you didn’t, you did get involved and there is a punishment that follows.

The district court engaged with Chavez’s concerns regarding the effects that the sentence and subsequent deportation would have on his family. We find that the district court’s statement of reasons was adequate, and in light of these considerations, the court’s decision to impose a sentence at the low end of the advisory guidelines range was reasonable in light of § 3553(a).

We are reluctant to address Panaigua–Verdugo’s argument regarding the reasonableness of his sentence, considering that he cribs Chavez’s argument wholesale without specifically examining how the argument applies to his own sentencing hearing. Regardless, we find nothing in the record to suggest that the district court failed to consider the § 3553(a) factors in imposing Panaigua–Verdugo’s sentence, and Panaigua–Verdugo presents nothing to disturb the rebuttable presumption of reasonableness of his within-guidelines sentence. See *Shannon*, 518 F.3d at 496.

Accordingly, we AFFIRM the sentences of Panaigua–Verdugo and Chavez.

Jerry N. JONES, Mary F. Jones, and Arline Winerman, Plaintiffs–Appellants,

v.

HARRIS ASSOCIATES L.P., Defendant–Appellee.

No. 07–1624.

United States Court of Appeals,
Seventh Circuit.

Aug. 8, 2008.

On Petition for Rehearing and Rehearing En Banc.

James C. Bradley, Richardson, Patrick, Westbrook & Brickman, Charleston, SC, Ernest Young, Austin, TX, for Plaintiffs–Appellants.
Gordon B. Nash, Jr., Drinker, Biddle & Reath, Chicago, IL, John D. Donovan, Jr., Brian R. Blais, Ropes & Gray, Boston, MA, for Defendant–Appellee.

Before EASTERNBROOK, Chief Judge, and KANNE and EVANS, Circuit Judges.

PER CURIAM.

The panel has voted unanimously to deny the petition for rehearing. A judge in active service called for a vote on the suggestion for rehearing en banc. A majority did not favor rehearing en banc, and the petition therefore is denied. Circuit Judge Ripple did not participate in the consideration or decision of this case.

POSNER, Circuit Judge, with whom Circuit Judges ROVNER, WOOD, WILLIAMS, and TINDER join, dissenting from denial of rehearing en banc.

This case merits the attention of the full court. The panel rejected the approach taken by the Second Circuit in Gartenberg v. Merrill Lynch Asset Management, Inc., 694 F.2d 923 (2d Cir.1982), to deciding whether a mutual fund adviser has breached his fiduciary duty to the fund, the duty created by section 36(b) of the Investment Company Act, 15 U.S.C. §§ 80a–1 et seq. Gartenberg permits a court to consider, as a factor in determining such a breach, whether the fee is “so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm’s-length bargaining.” 694 F.2d at 928. The panel opinion states that it “now disapprove[s] the Gartenberg approach. . . . A fiduciary must make full disclosure and play no tricks but is not subject to a cap on compensation.” Jones v. Harris Associates L.P., 527 F.3d 627, 632 (7th Cir.2008).

The opinion says that this court had previously suggested that the Gartenberg approach “is wanting.” Id. It cites Green v. Nuveen Advisory Corp., 295 F.3d 738, 743 n. 8 (7th Cir.2002), for this proposition, but neither in footnote 8 nor elsewhere in that opinion is there any suggestion that Gartenberg’s treatment of the issue of excessive fees is incorrect; Green was not an excessive-fee case. The panel cites another Green opinion, Green v. Fund Asset Management, L.P., 286 F.3d 682 (3d Cir. 2002), as suggesting disagreement with Gartenberg, but again the amount of compensation was not at issue.

regulations, are unwise on the ground that the case has not been made that the existing framework for regulation of funds and advisory fees is intrinsically flawed.” Id. at 213. It’s not as if Gartenberg has proved to be too hard on fund advisers. “Subsequent litigation [after Gartenberg] in excessive fee cases has resulted almost uniformly in judgments for the defendants . . . although there have been some notable settlements wherein defendants have agreed to prospective reduction in the fee schedule.” James D. Cox et al., Securities Regulation: Cases and Materials 1211 (3d ed.2001); see also James D. Cox & John W. Payne, “Mutual Fund Expense Disclosures: A Behavioral Perspective,” 83 Wash. U.L.Q. 907, 923 (2005).


Competition in product and capital markets can’t be counted on to solve the problem because the same structure of incentives operates on all large corporations and similar entities, including mutual funds. Mutual funds are a component of the financial services industry, where abuses have been rampant, as is more evident now than it was when Coates and Hubbard wrote their article. A business school professor at Northwestern University recently observed that “business connections can mitigate agency conflicts by facilitating efficient information transfers, but can also be channels for inefficient favoritism.” She found “evidence that connections among agents in [the mutual fund industry] foster favoritism, to the detriment of investors. Fund directors and advisory firms that manage the funds
hire each other preferentially based on past interactions. When directors and the management are more connected, advisors capture more rents and are monitored by the board less intensely. These findings support recent calls for more disclosure regarding the negotiation of advisory contracts by fund boards.” Camelia M. Kuhn-
abstract=849705 (visited July 28, 2008). The SEC’s Office of Economic Analysis (the principal adviser to the SEC on the economic aspects of regulatory issues) believes that mutual fund “boards with a greater proportion of independent directors are more likely to negotiate and approve lower fees, merge poorly performing funds more quickly or provide greater investor protection from late-trading and market timing,” although “broad cross-sectional analysis reveals little consistent evidence that board composition is related to lower fees and higher returns for fund shareholders.” “OEA Memorandum: Literature Review on Independent Mutual Fund Chairs and Directors,” Dec. 29, 2006, www.404.gov/rules/proposed/s70304/

A particular concern in this case is the adviser’s charging its captive funds more than twice what it charges independent funds. According to the figures in the panel opinion, the captives are charged one percent of the first $2 billion in assets while the independents are charged roughly one-half of one percent for the first $500 million and roughly one-third of one percent for everything above. The panel opinion throws out some suggestions on why this difference may be justified, but the suggestions are offered purely as speculation, rather than anything having an evidentiary or empirical basis. And there is no doubt that the captive funds are indeed captive. The Oakmark–Harris relationship matches the arrangement described in the Senate Report accompanying § 36(b): a fund “organized by its investment adviser which provides it with almost all management services.” S.Rep. No. 184, 91st Cong., 1st Sess. 41 (1969), quoted in Green v. Fund Asset Management, L.P., supra, 286 F.3d at 685. Financial managers from Harris founded the Oakmark family of funds in 1991, and each year since then the Oakmark Board of Trustees has reselected Harris as the fund’s adviser. Harris manages the entire Oakmark portfolio, which consists of seven funds. The Oakmark prospectus describes the relationship this way: “Subject to the overall authority of the board of trustees, [Harris Associates] furnishes continuous investment supervision and management to the Funds and also furnishes office space, equipment, and management personnel.” The Oakmark Funds, “Prospectus,” Jan. 28, 2008, p. 36, www.oakmark.com/fundlit/
literature.asp?selected=Prospectus# (visited July 28, 2008). Recall Professor Kuhn’s observation that “when directors and the management are more connected, advisors capture more rents and are monitored by the board less intensely.”

The panel opinion says that the fact “that mutual funds are ‘captives’ of investment advisers does not curtail this competition. An adviser can’t make money from its captive fund if high fees drive investors away.” 527 F.3d at 632. That’s true; but will high fees drive investors away? “[T]he chief reason for substantial advisory fee level differences between equity pension fund portfolio managers and equity mutual fund portfolio managers is that advisory fees in the pension field are subject to a marketplace where arm’s-length bargaining occurs. As a rule, [mutual] fund shareholders neither benefit from
arm’s-length bargaining nor from prices that approximate those that arm’s-length bargaining would yield were it the norm.” John P. Freeman & Stewart L. Brown, “Mutual Fund Advisory Fees: The Cost of Conflicts of Interest,” 26 J. Corp. L. 609, 634 (2001).

The panel opinion acknowledges that the level of compensation of trustees could be “so unusual that a court will infer that deceit must have occurred, or that the persons responsible for [the decision have abdicated.” 527 F.3d at 632. Compensation that is “so unusual” might not seem to differ materially from compensation that is “so disproportionately large.” But although one industry commentator has suggested that “courts may . . . conclude that in fact what the Court of Appeals has done [in Jones ] is merely articulate the Gartenberg standard in a different way,” “Seventh Circuit ‘Disapproves’ Gartenberg, But Is This New Approach Fundamentally Different?,” May 27, 2008, www.bingham.com/ Media.aspx?MediaID=7004 (visited July 28, 2008), this misses an important difference between the Gartenberg approach and the panel’s approach. The panel’s “so unusual” standard is to be applied solely by comparing the adviser’s fee with the fees charged by other mutual fund advisers. Gartenberg’s “so disproportionately large” standard is rightly not so limited. The governance structure that enables mutual fund advisers to charge exorbitant fees is industry-wide, so the panel’s comparability approach would if widely followed allow those fees to become the industry’s floor. And in this case there was an alternative comparison, rejected by the panel on the basis of airy speculation—comparison of the fees that Harris charges independent funds with the much higher fees that it charges the funds it controls.

The panel opinion points out that courts do not review corporate salaries for exces-siveness. That misses the point, which is that unreasonable compensation can be evidence of a breach of fiduciary duty.


The outcome of this case may be correct. The panel opinion gives some reasons why, though one of them is weak in its unelaborated form: that the funds managed by Harris have grown faster than the industry norm. One would need to know over what period they had grown faster to know whether other than random factors were at work. But the creation of a circuit split,