

Excessive Compensation in Publicly Held Corporations: Is The Doctrine Of Waste Still Applicable?

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I. Introduction

There has been a great deal of controversy recently concerning compensation paid by some of the largest corporations in the United States to their principal officers. For instance, The New York Attorney General, Eliot Spitzer, filed suit on May 24, 2004 against The New York Stock Exchange, its former Chairman, Dick Grasso, and the former Chairman of the Compensation Committee of the Board of Directors, for the recovery of over \$100,000,000 paid to Mr. Grasso as compensation.² The suit contends that the compensation paid to Mr. Grasso was unreasonable and the product of manipulation and intimidation.³ In a statement, Attorney General Spitzer says that the board of directors lacked proper information, stifled internal debate and failed to conduct a proper inquiry in its deliberations concerning the matter.⁴ Another recent article states that the board of directors of Cendant Corporation revised the employment contract of Henry Silverman, its CEO, in order to settle a derivative action filed in the Delaware Chancery Court alleging excessive compensation.⁵ Reportedly, Mr. Silverman received executive pay of \$60,100,000 in 2003, including a \$13,800,000 bonus and \$4,600,000

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² Kate Kelly & Susanne Craig, *Spitzer Files Suit Seeking Millions of Grasso Money --- Action Targets Ex-Chief of NYSE and Exchange Over \$200 Million Package*, Wall St. J. A1 (May 25, 2004).

³ *Id.*

⁴ *Id.* at A6.

⁵ Ryan Chittum, *Cendant Cuts Silverman's Benefits --- Chief Executive's Contract Also Is Shortened in Bid to Settle Compensation Suit*, Wall St. J. A3 (April 20, 2004).

paid in premiums on life insurance.⁶ These are just two of many recent examples of public reports of allegations of excessive executive compensation. The question naturally arises as to the legal right of stockholders to challenge what they perceive to be unreasonable or excessive compensation.

The payment of unreasonable or excessive compensation by public corporations may be challenged on two distinct bases.⁷ One basis involves a challenge based upon the doctrine of waste. The other basis involves a claim that the board of directors has breached its duty to act in good faith and with due care. The latter claim may be defended based upon the so-called business judgment rule. That rule protects the directors' decisions, without regard to their reasonableness, where the directors have been informed of all reasonably available material information concerning the subject matter to be decided and have acted in good faith in a manner that the directors believe to be in the best interest of the corporation. Essentially the rule provides that the quality of the decision is not determinative of liability, only the process utilized in reaching the decision is important. This article will focus solely upon the applicability of the doctrine of waste and leave to others a discussion of the business judgment rule.

The doctrine of waste has a well-established precedent in the law with respect to payment of compensation by corporations, as described nearly 72 years ago in the decision of the United States Supreme Court in the case of *Rogers v. Hill*.⁸ However, the continued viability of the doctrine is at issue, at least in the state of Delaware, in view of

⁶ *Id.*

⁷ This statement assumes that there is no conflict of interest involved in establishing executive compensation and that disinterested directors have established the amount of compensation to be paid utilizing normal corporate procedures. Otherwise, a different set of rules involving conflict of interests applies. Under these rules, the burden of establishing the reasonableness of the compensation is shifted to the directors.

⁸ *Rogers v. Hill*, 289 U.S. 582, 53 S. Ct. 731 (1933).

the Delaware Supreme Court decision in *Brehm v. Eisner*.⁹ The decision in *Brehm v. Eisner* is important because Delaware is the leading jurisdiction for articulating principles of law applicable to corporations.

This article contains a review of the early precedents involving public corporations wherein the doctrine of waste was established and applied, and more recent decisions by the Delaware Supreme Court that have addressed the doctrine of waste. It identifies apparent deficiencies in the understanding and application of the historic doctrine of waste by the Delaware Supreme Court. Indeed, if the principles enunciated by the Delaware Supreme Court are followed, the doctrine of waste will have been effectively revoked, while the court does not appear to have recognized this consequence of its decisions. Hopefully, this article will provide some much needed clarity to this area of the law.

II. The Early Development of the Doctrine of Waste.

The payment of substantial compensation to executive management of corporations in the United States first came about after World War I.¹⁰ By 1928, executives of some of the largest corporations received compensation as high as \$1,500,000 annually.¹¹ Following the depression years of 1929-1930, compensation fell dramatically but again turned up in the years immediately thereafter.¹² These events resulted in a flurry of litigation as to the reasonableness of compensation at some of these major corporations.¹³ These events also caused the United States Congress to direct the Federal Trade Commission to investigate corporate salaries paid during the years

⁹ *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000).

¹⁰ George T. Washington, *The Corporation Executive's Living Wage*, 54 Harv. L. Rev. 733, 734 (1941).

¹¹ *Id.*

¹² *Id.*

¹³ *Id.* at 735-736.

preceding the depression and to publish much of the resulting information.¹⁴ Due to Congress' concern about perceived excessive executive compensation, it passed legislation requiring public corporations to provide their shareholders with information about compensation paid to their executives.¹⁵

Most of the reported cases challenging the reasonableness of executive compensation decided prior to 1930 dealt with family or closely held corporations where the stockholders, executives, certain employees and their families are intertwined. When one faction no longer allowed another faction to participate fully in the corporation's business, litigation followed. The courts, noting the self-interest evident in such situations, generally reviewed the reasonableness of the compensation paid to the interested persons. The theory was that compensation must be reasonably related to the value of the services obtained by the corporation. If compensation were established by a board of directors composed of persons who were to receive the compensation or who had a personal interest therein, as was normally the case, then the court would not presume that the compensation established by the board was reasonable. Accordingly, if a minority stockholder challenged the reasonableness of the payments, a factual determination as to reasonableness was required by the court. However, where compensation was established by a board of directors composed of members who were disinterested therein and otherwise independent, the compensation was generally presumed to be reasonable. Under such circumstances, the court would not generally substitute its judgment for that of the board of directors. However, in a few cases, the minority stockholder challenging the reasonableness of compensation successfully

¹⁴ *Id.* at 735.

¹⁵ See the *Securities Exchange Act of 1934*, 15 U.S.C. § 78a et seq. (2005)

alleged that the payment constituted a waste of corporate assets; that is a gift of corporate assets. We will look to some of these cases to see how the doctrine of waste is applied.

As noted earlier, the seminal case addressing the doctrine of waste and the reasonableness of compensation paid by public corporations is *Rogers v. Hill*. The suit was a derivative action brought by a minority stockholder seeking the recovery of allegedly excessive compensation paid to the management of The American Tobacco Company.¹⁶ The stockholders of The American Tobacco Company had approved a plan to pay an annual bonus to the president and five vice-presidents of the company in the amount of 10% of the annual profits of the company earned each year over and above the profits earned in the year 1910.¹⁷ After several years of payments, due to the success of the corporation, the amount of the bonuses became quite large with the largest single bonus paid amounting to \$842,507 paid to the president in 1930.¹⁸

The Supreme Court stated in its opinion that while great weight should be given to the decision by the stockholders of The American Tobacco Company in approving the bonus plan (the plan was approved by a near unanimous vote), which the court said was presumably made in good faith and according to the stockholder's best judgment, this fact cannot justify the payment of salaries that are so large as to amount to spoliation or waste of corporate property.¹⁹ In that regard, the court quoted with approval the following statement made in a dissenting opinion issued by the Court of Appeals: "If a bonus payment has no relation to the value of services for which it is given, it is in reality a gift

¹⁶ 289 U.S. at 584-585.

¹⁷ *Id.* at 584 n. 1.

¹⁸ *Id.* at 585 n. 2.

¹⁹ *Id.* at 591.

in part, and the majority stockholders have no power to give away corporate property against the protest of the minority.”²⁰

The court held that the mere existence of the bonus plan and the payments made pursuant thereto did not, without proof of other facts, justify a determination of waste.²¹ However, because the amount of the payments had grown so large over the years, the court concluded that an evidentiary hearing should be held to determine whether the payments were reasonable.²² Accordingly, the case was sent back to the district court for a determination of the reasonableness of the payments made.²³

So what should we conclude from this decision? First, we should understand that the doctrine of waste was alive and applicable to the payment of compensation by public corporations in 1933. Waste is a gift of corporate assets. Neither the board of directors nor the majority of stockholders of a corporation has the right to give away corporate assets in the form of unreasonable compensation. Waste can occur in two different manners. One is the payment of compensation without any requirement for the performance of any services in return therefore. The other is the payment of too much compensation in return for the services received or expected to be received. Only the incremental amount in excess of the value of the services rendered is waste. The Supreme Court indicated that no matter how large the compensation paid as compared to the services rendered or to be rendered, no per se case of waste could be made out. Waste must be established based upon a factual presentation. Waste will not be

²⁰ *Id.* at 591-592.

²¹ *Id.* at 591.

²² *Id.* at 592.

²³ *Id.* at 591-592.

presumed. There must be some evidence as to the value of the services as compared to the value of the compensation paid.

The Supreme Court did not state in the opinion whether every plaintiff alleging waste by a publicly owned corporation is entitled to a full evidentiary hearing as to the reasonableness of compensation paid or whether only those who can meet some threshold test may proceed. By allowing all claims of waste to proceed, the court would obviously invite excessive litigation. On the other hand, by making the threshold too high, the court would be suppressing meritorious litigation. This issue is still open for resolution today.

Soon thereafter, the New York Supreme Court addressed the issue of excessive compensation in *Gallin v. National City Bank of New York*.²⁴ The court approved without comment a report of a referee.²⁵ The case involved payments made under a management incentive plan established by National City Bank of New York in 1923.²⁶ Under the plan 20% of the net profits of the company in excess of a specified amount, which represented an 8% return on capital invested by the stockholders, was to be paid annually to certain management executives.²⁷ The remaining 80% of net profits was to be paid to the stockholders.²⁸ The plan had been established by the board of directors without the approval of the stockholders, though the stockholders were made aware of the plan.²⁹

In the decision, the referee reported that at no time did more than three of the company's eight directors have any opportunity to participate in the plan, and the

²⁴ 155 Misc. 880, 281 N.Y.S. 795 (N.Y. Sup. Ct. 1935).

²⁵ *Id.* at 903, 281 N.Y.S. at 821.

²⁶ *Id.* at 884, 281 N.Y.S. at 799.

²⁷ *Id.*, 281 N.Y.S. at 799.

²⁸ *Id.*, 281 N.Y.S. at 799.

²⁹ *Id.*, 281 N.Y.S. at 799.

disinterested directors who approved the plan represented major stockholders of the company.³⁰ The referee said that since the major stockholders were disinterested, they obviously had no incentive to give away the corporation's assets to its management.³¹ The referee also noted that the disinterested directors of the company selected the persons who were entitled to participate in the plan.³² During the 6-year period that the plan was in effect, the capital surplus and undivided profits of the company increased 214% and the total net operating earnings of the company increased 185%, thereby causing the bonus payments to grow substantially in amount.³³ Apparently, there was no evidence introduced at the trial to establish that the amount of the compensation paid was excessive, with the plaintiffs apparently assuming that the magnitude of the payments alone established waste per se.

The referee, as did the trial court, relied extensively upon the decision of *Rogers v. Hill*.³⁴ Accordingly, the referee stated that the magnitude of the total compensation paid out by the company, in and of itself, did not establish waste or a breach of duty of the directors.³⁵ The referee also held that the directors were not negligent in establishing the plan, having acted with full knowledge of all material facts and in what they believed to be the best interest of all the stockholders, including themselves.³⁶

However, the referee introduced a new element with respect to the board of directors' role in approving executive compensation. The referee held that the directors breached their duty to the stockholders because payments made under the plan were

³⁰ *Id.* at 885, 281 N.Y.S. at 800.

³¹ *Id.*, 281 N.Y.S. at 800.

³² *Id.* at 889, 281 N.Y.S. at 804.

³³ *Id.* at 888-889, 281 N.Y.S. at 803-804.

³⁴ *Id.* at 885 & 886, 281 N.Y.S. 800-801.

³⁵ *Id.* at 887-888, 281 N.Y.S. 802-803.

³⁶ *Id.* at 891, 281 N.Y.S. at 806.

calculated improperly by management and approved by the board of directors without having an independent review of management's calculations.³⁷ Accordingly, the referee entered a judgment against the directors for over \$1,800,000.³⁸

In this regard, the referee stated the following:

The board of directors and executive committee of the company, to insure the proper computation of the management fund, should have intrusted that work to officers or employees in no manner interested in the management fund. Failure so to do constituted a breach of their duty as directors and subjects them to liability for the restoration of moneys improperly paid through such erroneous computations of the management fund."³⁹

This decision appears to be in full accord with the holding in *Rogers v. Hill*, while it introduces a new element with respect to the board of directors' responsibility in approving calculations of executive compensation to be paid out.

In 1939, the United States District Court in Delaware addressed the issue of excessive compensation in public corporations in the case of *Koplar v. Warner Bros. Pictures, Inc.*⁴⁰ This was a derivative suit against the directors of Warner Bros. Pictures, Inc. for paying excessive compensation to the three Warner brothers.⁴¹ The compensation included the issuance to them of a large block of common stock in the company.⁴² In its opinion, the court described the history of the company from its infancy and the critical contribution of the three Warner brothers to its success.⁴³ The court also mentioned the extensive publicity given to the large amount of compensation

³⁷ *Id.* at 893, 281 N.Y.S. at 808.

³⁸ *Id.* at 903, 281 N.Y.S. at 819.

³⁹ *Id.* at 893, 281 N.Y.S. at 808.

⁴⁰ 19 F. Supp. 173 (D. Del. 1939).

⁴¹ *Id.* at 174.

⁴² *Id.*

⁴³ *Id.* at 175-176.

paid by the company to the Warner brothers as a result of a United States Senate investigation in 1932.⁴⁴

In discussing its decision, the court mentioned that during the years 1929 through 1931 not a single stockholder voted against the re-election of the company slate of directors, which included the three Warner brothers, and not a single stockholder complained of the employment contract between the Warner brothers and the company during the period it was making a profit.⁴⁵ The court noted that in 1929, the company made over \$17,000,000, and for the first six months of fiscal 1930, the company made over \$10,000,000.⁴⁶ Thereafter, during the heart of the depression, the company began to lose money.⁴⁷

The court held that under the circumstances, the compensation paid to the Warner brothers, including the payment of \$10,000 per week and the grant of 90,000 shares of common stock (allegedly worth \$10,000,000⁴⁸), did not constitute a waste of corporate assets.⁴⁹ While the court inferred that compensation paid in the amounts shown may be immoral, it is legally defensible.⁵⁰ The court stated:

Salaries of \$10,000 a week are matched by salaries paid other top executives in this business. As a matter of morals such payments may be questioned. Directors have the power to award just compensation. That power should be used, not abused. Fair human requirements should set some limits to salaries. Extraordinary talent is not acquired. If it were, it would not be extraordinary. Doubtless it is an endowment, which the holder should not place on the auction block.⁵¹

⁴⁴ *Id.* at 183.

⁴⁵ *Id.*

⁴⁶ *Id.*

⁴⁷ *Id.*

⁴⁸ *Id.* at 184.

⁴⁹ *Id.* at 188.

⁵⁰ *Id.*

⁵¹ *Id.*

The district court in this case clearly followed the principles handed down in *Rogers v. Hill* and *Galin v. National City Bank of New York*

In 1941, the New York Supreme Court decided the case of *Heller v. Boylan*.⁵² This case involved a continuation of the dispute that was the subject of *Rogers v. Hill*. Here the plaintiff challenged the payment of bonuses to the executives of The American Tobacco Company for the years since 1921.⁵³ During that period, bonuses were paid aggregating more than \$10,000,000 in addition to substantial salaries.⁵⁴ The trial judge held that these payments were per se unreasonable.⁵⁵ The New York Supreme Court cited *Rogers v. Hill* and *Gallin v. National City Bank of New York* favorably as precedents throughout its opinion. The court noted that the amounts paid may seem immoral and an indictment of our economic system to some jurists.⁵⁶ It noted that some economists have advocated a ceiling on compensation.⁵⁷ But the court upheld the principles established in *Rogers v. Hill*. It concluded that the payment of compensation couldn't be held excessive per se due to its apparent unreasonableness to the trial court.⁵⁸ It concluded that a factual hearing was required in order to make such a determination.⁵⁹

The court then raised some problems that it believed would necessarily arise in any such factual determination by the trial court. It asked rhetorically whose compensation should be compared with the executives' compensation, those of persons in the same industry, those of persons in other industries or possibly that of the president of

⁵² 29 N.Y.S.2d 653 (N.Y. Sup. Ct. 1941).

⁵³ *Id.* at 665.

⁵⁴ *Id.*

⁵⁵ *Id.*

⁵⁶ *Id.* at 669.

⁵⁷ *Id.*

⁵⁸ *Id.* at 670.

⁵⁹ *Id.*

the United States.⁶⁰ It concluded this dialogue with the following statement: “Courts are ill-equipped to solve or even to grapple with these entangled economic problems.”⁶¹

While the court ruled in favor of the defendants, it emphasized the fact that it was not holding that the payments made were reasonable but only stating that it "cannot by any reliable standard" find them to be waste.⁶² No expert testimony had been provided as to this issue at the trial level. However, as did the court in *Galín v. National City Bank of New York*, the court in a rather lengthy analysis reviewed extensively the computations made by the company as to the amount of the bonuses to be paid under the formula approved by the stockholders.⁶³

In 1942, the New York Supreme Court had another occasion to revisit the issue of excessive compensation paid at a publicly owned corporation in the case of *Diamond v. Davis*.⁶⁴ Here a minority stockholder sued the United States Rubber Company for granting a substantial stock option to its president and Chairman of the Board.⁶⁵ The suit arose after the president exercised a portion of a stock option granted to him by the company, with the plaintiff alleging that the option profit constituted a gift of \$150,000 to him.⁶⁶ E. I. du Pont de Nemours & Co. was also made a defendant because it owned approximately 19% of the stock of United States Rubber Company and its representative on the board of directors had voted in favor of the stock option plan.⁶⁷ Virtually all of the stockholders of the company had approved the plan.⁶⁸

⁶⁰ *Id.* at 679.

⁶¹ *Id.* at 680.

⁶² *Id.*

⁶³ *Id.* at 575-680

⁶⁴ 38 N.Y.S.2d 103 (N.Y. Sup. Ct. 1942).

⁶⁵ *Id.* at 107-108.

⁶⁶ *Id.* at 108.

⁶⁷ *Id.* at 108 and 122-123.

⁶⁸ *Id.* at 110.

In upholding the grant of the stock option, the court stated that where most of the stockholders of a company approve a compensation plan, "it is most convincing proof not only of the absence of fraud but also that benefits honestly and reasonably flow from the practice."⁶⁹ It noted that five of the eight directors who voted for the plan were not officers or beneficiaries of the company's incentive compensation plan and that the president did not vote on the matter.⁷⁰ The New York Supreme Court in this decision continued to follow its earlier precedents of *Gallin v. National City Bank of New York* and *Heller v. Boylan*.

In 1942, a federal District Court in New York rendered a decision in the case of *Winkelman v. General Motors Corp.*⁷¹ This case involved a stockholder derivative action challenging compensation paid by General Motors under a bonus plan adopted in 1918 and amended from time to time thereafter.⁷² The plan essentially provided for the payment of bonuses to executives of the company aggregating 10% on the company's net income above an amount determined to be 6% (later increased to 7%) of capital employed.⁷³ The plan was terminated at the end of 1936.⁷⁴ The participants varied in number over the years with the minimum and maximum participation being 679 and 2889 persons, respectively, from 1923 through 1935.⁷⁵

The court noted that the corporation was very successful during many of the years covered by the plan.⁷⁶ For instance, during the years 1922 through 1929, assets of the corporation increased by 140%, sales by 225%, net income by 355% and return on capital

⁶⁹ *Id.* at 114.

⁷⁰ *Id.* at 114.

⁷¹ 44 F. Supp. 960 (S.D.N.Y. 1942).

⁷² *Id.* at 965 and 969.

⁷³ *Id.* at 965.

⁷⁴ *Id.* at 968.

⁷⁵ *Id.* at 966.

⁷⁶ *Id.* at 970.

averaged 29.45%.⁷⁷ The court held that the New York statute of limitations precluded any review of amounts paid before 1930, though it expressed its opinion that some of the amounts paid were sufficiently large as to constitute waste.⁷⁸ The court stated that certain payments thereafter were sufficiently large so as to require a factual hearing as to their reasonableness under the authority of *Rogers*.⁷⁹ However, the court then went on to conclude from the review that the payments were not excessive since the services rendered were equal in value to the amounts paid under the plan.⁸⁰ As did the courts in *Galín v. National City Bank of New York* and *Heller v. Boylan*, this court determined that there were problems with some of the calculations made under the bonus plan and that some of the payments made thereunder were not properly approved or were approved without a full disclosure of the facts.⁸¹

These are the principal early decisions cited by courts throughout the United States when confronted with the issue of excessive executive compensation. Another decision that is rarely referenced in unreasonable compensation cases but that is instructive in any review of the older precedents is *McQuillen v. National Cash Register Co.*⁸² The United States District Court of Maryland had occasion to determine whether a stock option given by the board of directors of National Cash Register Co. to its chairman in return for services to be rendered constituted excessive compensation and a waste of corporate assets.⁸³ At the time, National Cash Register was the largest manufacturer of

⁷⁷ *Id.*

⁷⁸ *Id.* at 967.

⁷⁹ *Id.* at 969.

⁸⁰ *Id.*

⁸¹ *Id.* at 970.

⁸² 27 F. Supp. 639 (D. Md. 1939)

⁸³ *Id.* at 641.

cash registers and accounting machines in the world.⁸⁴ The court reported that the earnings of the company had increased gradually from 1925 through 1929, decreased gradually from 1929 through 1931, resulted in a net loss in 1932 and 1933, and returned to profitability each year from 1934 through 1937.⁸⁵

The court dismissed the lawsuit as being without merit.⁸⁶ In its opinion, the court made some rather prophetic statements concerning the ability of courts to litigate the reasonableness of executive compensation. The court quoted with approval the following language from the very early case of *Wight v. Heublein*,⁸⁷ a case involving a dispute between two families, one which owned 2/3rds of the stock of a corporation and the other, which owned 1/3rd of the stock.⁸⁸

It is obviously not the province of a court of equity to act as the general manager of a corporation or to assume the regulation of its internal affairs. If the chosen directors, without interests in conflict with the interest of stockholders, act in good faith in fixing salaries or incurring other expenses, their judgment will not ordinarily be reviewed by the courts, however unwise or mistaken it may appear; but this is far from saying that equity will refuse to redress the wrong done to a stockholder by the action or policy of directors, whether in voting themselves excessive salaries or otherwise, which operates to their own personal advantage, without any corresponding benefit to the corporation under their control.⁸⁹

Thereafter the court went on to explain further what it intended by its approval of the above quote from *Wight v. Heublein*. It stated:

An issue as to the reasonable value of the services of officers is easily made. It is not intended that courts shall be called upon to make a yearly audit and adjust salaries.⁹⁰ . . .

We must distinguish between compensation that is actually wasteful and that which is merely excessive. The former is unlawful, the latter is not.

⁸⁴ *Id.* at 652.

⁸⁵ *Id.* at 654.

⁸⁶ *Id.* at 655.

⁸⁷ 238 F. 321 (4th Cir. 1916)

⁸⁸ *Id.* at 322.

⁸⁹ McQuillen, 27 F. Supp. at 651.

⁹⁰ *Id.*

The former is the result of a failure to relate the amount of compensation to the needs of the particular situation by any recognized business practices, honestly, even though unwisely adopted, -- namely, the result of bad faith, or a total neglect of or indifference to such practices. Excessive compensation results from poor judgment, not necessarily from anything else.⁹¹

This court for the first time articulated a difference between excessive compensation and wasteful compensation. But no clear test or standard is provided for making such a determination. The court focused upon the process by which the compensation was approved and the good faith of the directors (the business judgment rule). The court references the use of recognized business practices by the board of directors in establishing compensation as compared to a total neglect of or indifference to such practices. This idea of tying waste exclusively to a failure to follow recognized business practices due to bad faith, total neglect or indifference appears contrary to the opinions expressed in the other leading cases. The court implies that a gift of corporate property is not waste if there is no bad faith or total neglect or indifference to recognized business practices. As the U. S. Supreme Court stated in *Rogers v. Hill*, if a bonus has no relationship to the value of the services rendered, it is a gift and cannot be approved by the board of directors or a majority of the stockholders, even where their actions are made in good faith. While it appears that the District Court had no intention of reversing *Rogers v. Hill*, its statements appear in conflict with the earlier decision.

Following the spurt of litigation that occurred immediately after the depression, litigation concerning excessive compensation at public corporations seems to have subsided. This may be due to the adoption of the Securities Exchange Act of 1934, which in part required that extensive information concerning executive compensation of

⁹¹ *Id.* at 653.

the highest paid executives of a publicly owned corporation had to be disclosed in proxy solicitation materials.⁹² Litigation continued concerning the payment of unreasonable compensation by closely held corporations, and the courts in these cases frequently cited *Rogers v. Hill* and its progeny as applicable precedent for their rulings.

All of the earlier cases, except *McQuillen v. National Cash Register Co.* are consistent in holding that the payment of compensation so large as to have no reasonable relationship to the value of the services rendered or to be rendered constitutes waste, and waste may not be approved by the stockholders or the board of directors of a corporation over the objections of a minority stockholder. Furthermore, they uniformly establish that no matter how large the compensation may appear to the court, it is not waste per se. Waste can only be established through an evidentiary hearing. These courts do not state how the court can determine on the basis of the allegations of the complaint alone when an evidentiary hearing should be allowed and when the complaint should be summarily dismissed. This failure will become more glaring upon a review of the recent Delaware cases concerning unreasonable executive compensation.

III. A Review and Analysis of the Earlier Delaware Cases.

In 1952, the Delaware Supreme Court decided *Gottlieb v. Heyden Chemical Corp.*⁹³ There the plaintiff sued the corporation to have certain stock options issued under a plan by the defendant corporation cancelled and to enjoin any further issuance of stock options under the plan.⁹⁴ The Chancery Court in Delaware entered judgment for the

⁹² See *supra* n. 13.

⁹³ 33 Del.Ch. 82, 90 A.2d 660 (Del. 1952).

⁹⁴ *Id.* at 82, 90 A.2d at 660.

defendant.⁹⁵ The Supreme Court of Delaware reversed and sent the case back to the lower court for a full evidentiary hearing.⁹⁶

The Supreme Court clearly understood *Rogers v. Hill* to establish that compensation paid by a corporation to the extent it is excessive constitutes a gift of corporate property and is improper.⁹⁷ The court, citing *Rogers v. Hill*, stated the following: “Certainly gifts to themselves or to their business associates will not avail against the vote of any qualified objector. Since a gift may be a gift in part only, a totally inadequate consideration, of course, invokes the same principle as the absence of any at all.”⁹⁸

The Delaware Supreme Court decided *Kerbs v. California Eastern Airways, Inc.*⁹⁹ the same day it decided *Gottlieb v. Heyden Chemical Corp.* There the plaintiff sued the corporation to enjoin the issuance of stock under a stock option plan and the payment of bonuses under a profit sharing plan.¹⁰⁰ Though five of the eight directors were beneficiaries under the plans, the stockholders of the corporation approved the plans.¹⁰¹ The court again stated that majority stockholders couldn’t ratify or approve a gift of corporate property over the objection of any stockholder.¹⁰² The court said that it was not called upon to decide whether there was a reasonable relationship between the benefits to be received by the corporation and the amount of compensation to be paid to the employees under the stock option plan because the stock option plan was deficient as a

⁹⁵ *Id.* at 87, 90 A.2d at 663.

⁹⁶ *Id.* at 95, 90 A.2d at 668.

⁹⁷ *Id.* at 91, 90 A.2d at 665.

⁹⁸ *Id.*, 90 A.2d at 665.

⁹⁹ 33 Del.Ch. 69, 90 A.2d 652 (Del. 1952).

¹⁰⁰ *Id.* at 71, 90 A.2d at 654.

¹⁰¹ *Id.* at 73, 90 A.2d at 655.

¹⁰² *Id.* at 73-74, 90 A.2d at 655.

matter of law.¹⁰³ The court held that there was no consideration to be received by the corporation under the stock option plan since the options granted thereunder could be exercised immediately by the employees even if they terminated their employment immediately.¹⁰⁴ The court, citing *Rogers v. Hill*, held that there was insufficient evidence before it to allow a determination of whether the profit sharing plan was wasteful.¹⁰⁵ In that regard, the court said:

With respect to the objection of the plaintiffs that the value of the services bears no reasonable relationship to the amounts to be paid under the plan, we cannot say, looking at the scheme of the profit-sharing plan and the amounts to be paid under it on the basis of past and anticipated earnings, that those amounts are so large as, in effect, to amount to spoliation or waste of the corporate assets. In view of the present earnings of the corporation, the amounts to be paid under the plan do not seem shockingly large. There is nothing in the record before us to demonstrate the persons to whom the amounts will be paid will not render services bearing a reasonable relation to those amounts.¹⁰⁶

This decision and the Gottlieb decision are clearly decided in accordance with the principles set out in *Rogers v. Hill* and its progeny to the effect that (1) stockholders and directors may not under any circumstances approve compensation that amounts to waste, (2) compensation paid by a corporation in excess of the fair value of the services received or to be received by it in the future constitutes waste, and (3) there is no presumption of waste even though the magnitude of the compensation paid or to be paid may appear shocking to the court.

The Delaware Supreme Court also clearly stated that a gift of corporate property is improper even where the board of directors acts honestly believing that the transaction is in the best interest of the corporation. In that regard it said:

¹⁰³ *Id.* at 75, 90 A.2d at 656.

¹⁰⁴ *Id.* at 77, 90 A.2d at 657.

¹⁰⁵ *Id.* at 78, 90 A.2d at 658.

¹⁰⁶ *Id.*, 90 A.2d at 658.

Honest directors conceivably might give away to their associates in the enterprise substantial amounts of a corporation's property in the belief that the gift would produce such gratitude that ultimately the corporation's generosity would be more than repaid. There would be nothing immoral or dishonest about such an action, but it would not be legally sound.¹⁰⁷

In 1979, the Delaware Supreme Court decided *Michelson v. Duncan*.¹⁰⁸ There a stockholder of Household Finance Corporation sued to set aside stock options granted to key employees pursuant to a company stock option plan.¹⁰⁹ The stock option plan originally allowed for the exercise of the options over a 9-year period but was later amended to reduce the period to 4 years.¹¹⁰ In 1974, following a dramatic decline in the market price of the corporation's stock, the board of directors cancelled previous options issued and replaced them with new options at a lower price.¹¹¹ This was done in order to restore some incentive for the employees.¹¹² The exercise price of the new options was between \$7 and \$18 below the exercise price of the old options.¹¹³

The plaintiff's claim was dismissed by the trial court on a motion for summary judgment for failure to plead facts that constituted waste.¹¹⁴ The Delaware Supreme Court reversed the dismissal and returned the case for trial.¹¹⁵ In its decision, the court described the doctrine of waste in the following manner:

The essence of a claim of gift is lack of consideration. The essence of a claim of waste of corporate assets is the diversion of corporate assets for improper or unnecessary purposes. Although directors are given wide latitude in making business judgments, they are bound to act out of fidelity and honesty in their roles as fiduciaries. (Citations omitted) And they may not, simply because of their position, 'by way of excessive salaries

¹⁰⁷ *Gottlieb*, 33 Del. Ch. at 88, 90 A.2d at 663-664.

¹⁰⁸ 407 A.2d 211 (Del. 1979).

¹⁰⁹ *Id.* at 214.

¹¹⁰ *Id.* at 215.

¹¹¹ *Id.*

¹¹² *Id.*

¹¹³ *Id.*

¹¹⁴ *Id.* at 214.

¹¹⁵ *Id.*

and other devices, oust the minority of a fair return upon its investment.’ (Citation omitted) It is common sense that a transfer for no consideration amounts to a gift or waste of corporate assets.¹¹⁶

The court here mixes two distinct concepts. One is the doctrine of waste and the other is the doctrine of breach of fiduciary duty (“fidelity and honesty”). Clearly, an honest board of directors acting in good faith may commit waste by authorizing the payment of money for which the corporation receives no equivalent benefit. That is what happened in *Kerbs v. California Eastern Airways, Inc.* However, the above quoted statement does not make this principle of law clear.

In its opinion, the court also confirmed the principle that waste may not be approved by a majority of the stockholders over the objection of a minority stockholder.¹¹⁷ It said that while stockholders may ratify the actions of the officers and directors that are beyond their authority, they may not confirm waste: “It is only where a claim of gift or waste of assets, fraud or Ultra vires is asserted that a less than unanimous shareholder ratification is not a full defense.”¹¹⁸

While the court stated that an allegation of waste is seldom dismissed on a motion for summary judgment, it referenced Section 157 of the Delaware Corporate Law relating to the issuance of rights to purchase stock of a corporation.¹¹⁹ The court states that the statute provides as follows: “In the absence of actual fraud in the transaction, the judgment of the directors as to the consideration for the issuance of such rights or options and the sufficiency thereof shall be conclusive.”¹²⁰

¹¹⁶ *Id.* at 217.

¹¹⁷ *Id.* at 218-219.

¹¹⁸ *Id.* at 219.

¹¹⁹ *Id.* at 223-224.

¹²⁰ *Id.*

The court noted that the statute was not applicable since implicit in the statute is the fact that some consideration has been given in return for the issuance of the rights or options referenced, while in the present case the plaintiff has alleged that there was no consideration given in return for the options issued.¹²¹ The court specifically reserved for a later date the issue of whether Section 157 disposes of an inadequacy of consideration claim.¹²² This statute may very well dispose of all inadequacy of consideration claims relating to the issuance of stock options or related rights in Delaware but it does not do so with respect to claims of waste relating to other forms of compensation.

IV. A Review and Analysis of the Later Delaware Cases.

In 1984, the Delaware Supreme Court decided the case of *Aronson v. Lewis*.¹²³ This was a derivative lawsuit by a stockholder against the corporation and the board of directors challenging an employment agreement between the corporation and Leo Fink, one of its directors and its principle stockholder.¹²⁴ Mr. Fink owned 47% of the corporation's stock.¹²⁵ The plaintiff sought a cancellation of the employment contract and the recovery of damages from the directors including Mr. Fink.¹²⁶

The Delaware Supreme Court dismissed the complaint for failure of the plaintiff to make demand on the corporation for it to pursue the claim before filing suit as required by Chancery Rule 23.1.¹²⁷ The court noted that no facts were alleged to show that a

¹²¹ *Id.* at 224.

¹²² *Id.*

¹²³ 473 A.2d 805 (Del. 1983).

¹²⁴ *Id.* at 809.

¹²⁵ *Id.* at 808.

¹²⁶ *Id.* at 809.

¹²⁷ *Id.* at 818. According to the decision, Chancery Rule 23.1 provided in pertinent part the following: "In a derivative action brought by 1 or more shareholders or members to enforce a right of a corporation or of an unincorporated association, the corporation or association having failed to enforce a right which may properly be asserted by it, the complaint shall allege that the plaintiff was a shareholder or member at the time of the transaction of which he complains or that his share of membership thereafter devolved on him

majority of the members of the board of directors breached their fiduciary duty or lacked sufficient independence to evaluate the claim, which is necessary in Delaware in order to waive the requirement of Chancery Rule 23.1 to make demand on the corporation to bring suit.¹²⁸

The decision is confusing for several reasons. It is not made clear in the context of a waste allegation why demand on the corporation is required. Previous decisions have clearly held that waste cannot be approved by directors or stockholders, so any decision by the board of directors not to pursue a legitimate waste claim would be invalid. It seems that the corporation's decision is solely whether to take charge of the litigation or leave it to the stockholder to pursue in a derivative claim.¹²⁹ The court also concluded that there was an insufficient allegation of facts in the complaint to show waste. In that regard the court said:

In essence, the plaintiff alleged a lack of consideration flowing from Fink to Meyers, since the employment agreement provided that compensation was not contingent on Fink's ability to perform any services. The bare assertion that Fink performed 'little or no services' was plaintiff's conclusion based solely on Fink's age and the existence of the Fink-Prudential employment agreement.¹³⁰

The court fails to make clear why the complaint is inadequate. What more is there to say other than that someone is being paid for the performance of "little or no services." It will require evidence to establish whether the services performed, if any, or to be performed in the future are of equal value to the payments being made.

by operation of law. The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority and the reasons for his failure to obtain the action or for not making the effort." See n. 1 at 808.

¹²⁸ *Id.*

¹²⁹ Previous decisions have held that whether waste has in fact occurred can only be determined by the court following an evidentiary hearing. It cannot be generally determined per se.

¹³⁰ *Aronson*, 473 A.2d at 817.

In *Grobow v. Perot*,¹³¹ a stockholder of General Motors Corporation alleged the waste of corporate assets in connection with the repurchase of a certain class of shares of stock from H. Ross Perot.¹³² Again, the Delaware Supreme Court dismissed a complaint for failure of the plaintiff to make demand on the corporation to pursue the claim as required by Chancery Rule 23.1.¹³³ In its opinion, the court focused at length upon the requirements necessary for a pleading in order to obtain a waiver of the demand requirement of Chancery Rule 23.1.¹³⁴ The court says that the complaint must state facts establishing a reasonable doubt as to whether the directors are entitled to the protection of the business judgment rule or are acting independently.¹³⁵ The court characterizes the allegations of the complaint as follows: “[P]laintiffs allege that the premium paid Perot constituted a prima facie waste of GM’s assets. Plaintiffs argue that the transaction, on its face, was ‘so egregious as to be afforded no presumption of business judgment protection.’”¹³⁶

But the court responds to the plaintiff’s allegations as follows: “[P]laintiffs have failed to plead with particularity facts sufficient to create a reasonable doubt that the substantive terms of the repurchase fall within the protection of the business judgment rule.”¹³⁷

Accordingly, the court concluded with the following statement:

We hold that the complaints as amended fail to allege facts sufficient to create a reasonable doubt that the GM Board-approved repurchase transaction is not within the protection of the business judgment rule; thus,

¹³¹ 539 A.2d 180 (Del. 1988).

¹³² *Id.* at 183-185

¹³³ *Id.* at 180.

¹³⁴ *Id.*

¹³⁵ *Id.*

¹³⁶ *Id.* at 189.

¹³⁷ *Id.* at 190.

the plaintiffs have failed to establish the futility of demand required under *Aronson* and *Pogostin* for casting reasonable doubt thereon.¹³⁸

Once again, we are left without any clear understanding as to whether the Delaware Supreme Court is changing the rules previously thought to apply to actions alleging waste. The board of directors cannot approve waste, and their decision not to pursue a legitimate claim of waste cannot therefore be allowed to stand. The board's decision is not whether the claim should be pursued but whether they want to pursue it or allow it to be pursued by others.

In *Brehm v. Eisner*,¹³⁹ the Delaware Supreme Court again addressed an allegation of corporate waste. The case involved a challenge to compensation paid to Michael Ovitz by The Walt Disney Company upon his termination from employment.¹⁴⁰ He was hired pursuant to a 5-year contract to be the successor to Michael Eisner, the Chairman and Chief Executive Officer of the corporation.¹⁴¹ The contract, dated October 1, 1995, provided for a salary of \$1,000,000 annually, the payment of a bonus at the discretion of the board of directors, and the issuance of certain stock options.¹⁴² It further provided that upon termination without cause, Mr. Ovitz is to receive the present value of the remaining salary to be paid under his contract plus \$10,000,000, an additional \$7,500,000 for each year remaining under the contract and the right to exercise options for 3,000,000 shares of common stock of Disney.¹⁴³ The board of directors terminated Mr. Ovitz without cause effective December 27, 1996.¹⁴⁴ According to the agreement of

¹³⁸ *Id.* at 192.

¹³⁹ 746 A.2d 244 (Del. 2000).

¹⁴⁰ *Id.* at 248.

¹⁴¹ *Id.* at 249-250.

¹⁴² *Id.*

¹⁴³ *Id.* at 250 and 252-253.

¹⁴⁴ *Id.* at 252.

termination approved by the board of directors, Mr. Ovitz was to be paid \$38,888,230.77 and allowed to exercise stock options worth approximately \$101,000,000.¹⁴⁵

Various stockholders sued the 1995 board of directors of Disney alleging a breach of the duty of care required of directors due to their approval of the contract of employment with Ovitz and for waste.¹⁴⁶ They also sued the 1996 board of directors of Disney alleging a breach of duty of care for agreeing to a termination of Ovitz without cause and for waste.¹⁴⁷ The Delaware Supreme Court dismissed the complaint for failure of the plaintiffs to make demand upon the corporation to bring suit as required by Chancery Rule 23.1.¹⁴⁸

In its opinion, the court early on states that: “On the one hand, it appears from the Complaint that: (a) the compensation and termination payout for Ovitz were exceedingly lucrative, if not luxurious, compared to Ovitz’ value to the Company; . . . ”¹⁴⁹

But then the court states that: “On the other hand, the Complaint is so inartfully drafted that it was properly dismissed under our pleading standards for derivative suits.”¹⁵⁰

Thereafter the court turns its attention to the failure of the plaintiff to make a pre-suit demand, as it did in *Aronson v. Lewis* and *Grobow v. Perot*. The court says:

Moreover, the sheer size of the payout to Ovitz, as alleged, pushes the envelope of judicial respect for the business judgment of directors in making compensation decisions. Therefore, both as to the processes of the two Boards and the waste test, this is a close case.

But our concerns about lavish executive compensation and our institutional aspirations that boards of directors of Delaware corporations

¹⁴⁵ *Id.* at 252-253.

¹⁴⁶ *Id.* at 248-249 and 251-253.

¹⁴⁷ *Id.* at 248-249 and 253.

¹⁴⁸ *Id.* at 262 and 267.

¹⁴⁹ *Id.* at 249.

¹⁵⁰ *Id.* at 249.

live up to the highest standards of good corporate practices do not translate into a holding that these plaintiffs have set forth particularized facts excusing a pre-suit demand under our law and our pleading requirements.¹⁵¹

Later in the opinion, the court summarizes what it concludes the suit is about as follows: “This is a case about whether there should be personal liability of the directors of a Delaware corporation to the corporation for lack of due care in the decisionmaking process and for waste of corporate assets.”¹⁵²

The court then states its conclusion as follows: “But the Complaint fails on its face to meet the waste test because it does not allege with particularity facts tending to show that no reasonable business person would have made the decision that the New Board made under these circumstances.”¹⁵³

In its opinion, the court provides us with the most comprehensive statement yet as to what it believes is necessary to establish waste.

The judicial standard for determination of corporate waste is well developed. Roughly, a waste entails an exchange of corporate assets for consideration so disproportionately small as to lie beyond the range at which any reasonable person might be willing to trade. Most often the claim is associated with a transfer of corporate assets that serves no corporate purpose; or for which no consideration at all is received. Such a transfer is in effect a gift. If, however, there is *any substantial* consideration received by the corporation, and if there is a *good faith judgment* that in the circumstances the transaction is worthwhile, there should be no finding of waste, even if the fact finder would conclude *ex post* that the transaction was unreasonably risky.¹⁵⁴

V. The Current Confusion in the Delaware Supreme Court.

The Delaware Supreme Court has mixed and confused several distinct issues of law involved in their decisions in *Aronson v. Lewis*, *Grobow v. Perot* and *Brehm v.*

¹⁵¹ *Id.* at 249.

¹⁵² *Id.* at 255.

¹⁵³ *Id.* at 266.

¹⁵⁴ *Id.* at 263.

Eisner. This confusion, unless carefully untangled, will have the effect of erasing the long-standing doctrine of waste. One commentator apparently believes these decisions have already had this effect.¹⁵⁵

Let us look at application of the demand requirement under corporate law (Chancery Rule 23.1 in Delaware) and its relationship to the doctrine of waste. Then we will look at the application of the business judgment rule to the liability of directors and its relationship to the doctrine of waste.

In *Aronson v. Lewis* and *Grobow v. Perot*, the Delaware Supreme Court premised dismissal of the complaint upon the failure of the plaintiff to make demand upon the corporation as required under Chancery Rule 23.1. Failure to comply with Chancery Rule 23.1 also appears to have been a factor in *Brehm v. Eisner*; however, in reaching its decision the court also focused heavily upon the inartful drafting of the complaint and the issue of whether the directors can be held liable for waste without allegations establishing a violation of the business judgment rule.

The rule requiring that first demand be made on a corporation before proceeding with a derivative action is typical of most corporation law statutes. The purpose of the rule is to allow the directors, who are charged by the stockholders with the responsibility for managing the corporation, to determine whether it is in the best interest of the corporation to proceed with the lawsuit. Demand is excused under the rule where the directors cannot make a good faith determination due to a lack of independence or where the directors fail to comply with the business judgment rule in arriving at their decision.

¹⁵⁵ Randall S. Thomas & Kenneth J. Martin, *Litigating Challenges to Executive Pay: An Exercise in Futility*, 79 Wash. U. L. Q. 569, 578 (2001). The author states that if corporations use compensation committees composed of independent directors, which most do, they may be effectively immune from judicial review.

The demand requirement allows the board of directors to determine whether the stockholder's complaint should be pursued by the corporation, depending upon what is in the best interest of the corporation. If the stockholder has prematurely filed the derivative action and the board of directors decides to continue the litigation, it may simply ask the court for permission to take charge of the prosecution of the case and be substituted as the plaintiff. If it believes the case should be dismissed, it would ask the court to dismiss the lawsuit, it being in the best interest of the corporation to do so. However, when an allegation of waste has been made, the court is not in a position to dismiss the case, even if the board of directors believes that it is in the best interest of the corporation to do so, unless the court determines factually that no waste has occurred.

For instance, assume that the court makes no determination as to whether waste has occurred. Then there exist two possibilities, one that waste has occurred and the other that waste has not occurred. If the court dismisses the lawsuit and waste has occurred, the basis for the dismissal is that no demand was made on the corporation and the board of directors may have concluded that the lawsuit was not in the best interest of the corporation. The problem with this result is that it constitutes a reversal of the long-standing principle that the board of directors cannot sanction waste adopted by every court that has dealt with waste. Therefore, the court must determine factually whether waste has occurred before it can allow a dismissal of the suit for failure to make a demand on the corporation or effectively revoke this long standing rule relating to waste.

The court, in *Brehm v. Eisner*, touched upon another possibility when it stated that the complaint is so inartfully drafted that it may fail to allege a case of waste. This raises the issue of whether a complaint should ever be dismissed as a matter of law for failure to

allege facts constituting waste. Under the historical precedents, there has been no test adopted for determining when an allegation of waste should be dismissed summarily, and the Delaware Supreme Court has not explicitly proposed any such test. Under all of the historic precedents, waste can only be determined following an evidentiary hearing. So for summary judgment purposes, waste has historically been presumed. However, in none of these cases were the allegations trivial in nature. All of the cases involved payments of compensation bordering on the extreme. But that is also true in *Brehm v. Eisner*. To simply dismiss the complaint as a matter of law on the basis that the amount of compensation paid was not waste without the application of any objective test nor any factual hearing, would violate all of the earlier precedents precluding summary judgment where waste is alleged.

Now, let us look at the application of the business judgment rule as it applies to an allegation of waste. If the directors of a corporation commit waste, they may be liable for their actions. Generally, independent directors of a corporation are provided the protection of the business judgment rule with respect to their decisions. That rule shields directors from liability if they act in good faith in what they reasonably believe to be in the best interest of the corporation, and they have considered in their deliberations all material facts reasonably available to them in making their decisions.¹⁵⁶ The test is focused upon their good faith and the process employed by them in arriving at their decisions.¹⁵⁷ The quality of the directors' decisions is not at issue. As the court stated in *Brehm v. Eisner*:

¹⁵⁶ The business judgment rule is discussed in Aronson, 473 A2d at 812.

¹⁵⁷ The directors may also be protected by provisions in the corporation's Articles of Incorporations or bylaws eliminating liability or by express provisions in contracts with the directors.

It is the essence of the business judgment rule that a court will not apply 20/20 hindsight to second guess a board's decision, except 'in rare cases [where] a transaction may be so egregious on its face that the board approval cannot meet the test of business judgment'.¹⁵⁸

A similar analysis would be made under the Model Business Corporation Act. Section 8.31 of the 1984 draft of the Act provides that independent directors are not liable except where they fail to act in good faith or in what they believe to be the best interest of the corporation, fail to be reasonably informed about the matters to be considered or devote appropriate attention to the matters to be considered. Most states have adopted some form of the Act or have used it as a template for their statutes relating to corporations. Therefore, most states would probably recognize the precedents adopted in Delaware with respect to director liability. However, application of the business judgment rule to defeat a claim against the directors of a corporation should not necessarily result in a complete disposition of a case alleging waste. Even where the directors are shielded from liability for waste, a lawsuit alleging waste should not be dismissed unless director liability is the sole issue involved. For instance, a stockholder of a corporation may be entitled to an injunction or other relief precluding the corporation from committing waste or continuing to do so.¹⁵⁹ A stockholder may also seek on behalf of the corporation a recovery of waste from the recipient thereof since waste is a gift, a payment for which no consideration has been received by the corporation.

Let us assume that the directors of a public corporation have no personal liability for a compensation decision because they are shielded by the business judgment rule. A plaintiff alleging waste with respect to an employment contract between an officer and

¹⁵⁸ *Behm*, 746 A.2d at 260.

¹⁵⁹ Note that the stockholder in *Gottlieb v. Hayden Chemical Corp.* sued for an injunction, and the stockholder in *Aronson v. Lewis* sued for a cancellation of the employment contract.

the corporation is still entitled to seek relief on behalf of the corporation such as a rescission of the employment contract, an injunction against the corporation and its officers and directors from honoring the contract and/or the recovery of payments to the officer constituting waste. For instance, in *Brehm v. Eisner*, Michael Ovitz, the employee who was to receive the compensation, and The Walt Disney Company were defendants in addition to the individual directors. As the earlier cases clearly stated, neither the directors nor the majority stockholders may sanction waste, so even if no case for liability can be made out against the directors under the business judgment rule, the plaintiffs should have been allowed to proceed against the other parties seeking alternative forms of relief.

The Delaware Supreme Court also seems to confuse the element of good faith judgment of the board of directors, which may protect the directors under the business judgment rule, with a determination of waste. While a good faith determination may be strong evidence that the compensation paid is not waste, it is not conclusive. In many of the earlier precedents reviewed, the boards of directors were acting in good faith but the resulting disposition of the claim of waste was not determined on that fact alone. The board of directors may have had incomplete or inaccurate information at the time of its deliberations, have made a poor business decision, or simply made a mistake in understanding the terms of the compensation arrangement. While the board of directors may have no liability for their actions due to the protection of the business judgment rule, the compensation arrangement may still constitute waste, which would entitle the complaining stockholder to some form of remedy other than recovery of damages from the directors.

It appears that the Delaware Supreme Court is wrestling with the same issue recognized by the district judge in *McQuillen v. National Cash Register Co.*¹⁶⁰ There the court attempted to distinguish between “wasteful” and “excessive” compensation, one being unlawful and the other not so.¹⁶¹ The district judge in *McQuillen* essentially says that waste results solely from bad faith or the total neglect of or indifference to recognized business practices.¹⁶² The Delaware Supreme Court may be saying the same thing as the district judge in *McQuillen*, that where the board of directors satisfies the business judgment rule, there can be no waste. However, this would be a complete departure from all of the earlier precedents involving waste, both in Delaware and elsewhere.

VI. Conclusion.

In conclusion, the Delaware Supreme Court has failed to apply the traditional doctrine of waste in its most recent decisions. The court has treated these cases alleging waste as ordinary derivative lawsuits involving allegations of director misconduct, dismissing them for failure to make demand or for failure to allege facts showing that the business judgment rule has been violated. However, traditional waste cases are unique and cannot be dismissed in this manner without destroying the traditional concept of waste.

Under the long-standing doctrine of waste, waste cannot be sanctioned by the board of directors or by the stockholders of a corporation over the objection of any stockholder. Furthermore, there is no threshold test to be applied to determine if a

¹⁶⁰ *McQuillen*, 27 F. Supp. at 653.

¹⁶¹ *Id.*

¹⁶² *Id.*

complaint should be dismissed on summary judgment nor is there any per se test to apply to establish waste as a matter of law. An evidentiary hearing is always required. If the Delaware Supreme Court desires to change these long standing precedents, it should do so explicitly.

Naturally the question arises concerning what the court should do to untangle these issues while maintaining a careful balance between the rights of stockholders and the duties and responsibilities of directors. This issue will be addressed in a subsequent article to be published soon.