The Harvard Law School Forum on Corporate Governance and Financial Regulation

SUPPORTED BY: CSC CORPORATION SERVICE COMPANY

Delaware Court Upholds Board Discretion in Setting Compensation Practices

Posted by Paul Rowe, Wachtell, Lipton, Rosen & Katz, on Saturday November 19, 2011

Editor's Note: Paul Rowe is a Partner in the Litigation Department at Wachtell, Lipton, Rosen and Katz. This post is based on a Wachtell Lipton memorandum by Mr. Rowe, Jeannemarie O'Brien, and Jeremy Goldstein. This post is part of the Delaware law series, which is co-sponsored by the Forum and Corporation Services Company; links to other posts in the series are available here.

In dismissing a wide-ranging stockholder challenge to compensation practices at Goldman Sachs, the Delaware Court of Chancery has issued a strong reaffirmation of traditional principles of the common law of executive compensation. The decision emphasizes that boards are free to encourage and reward risk-taking by employees and that Delaware law protects directors who adopt compensation programs in good faith. *In re The Goldman Sachs Group, Inc. Shareholder Litigation (Oct. 12, 2011)*.

Shareholders of Goldman Sachs brought suit on a variety of theories, claiming that Goldman's compensation policies, which emphasized net revenues, rewarded employees with bonuses for taking risks but failed to penalize them for losing money; that the directors allocated too much of the firm's resources to individual compensation versus investment in the business; that while the firm adopted a "pay for performance" philosophy, actual pay practices failed to align stockholder and employee interests; and that the board should have known that the effect of the compensation practices was to encourage employees to engage in risky and/or unlawful conduct using corporate assets. In dismissing the claims, the Court relied on basic principles of Delaware law.

In particular, the Court notes that "[t]he decision as to how much compensation is appropriate to retain and incentivize employees, both individually and in the aggregate, is a core function of a board of directors exercising its business judgment." If the shareholders disagree with the board's judgment, their remedy is to replace board members through "directorial elections." The decision further states that "it is the essence of business judgment for a board to determine if a particular individual warrants large amounts of money" as payment for services. Recognizing that boards set compensation in part as a function of encouraging appropriate risk-taking by employees, the court reasoned that even when risk-taking leads to substantial losses, "there should be no finding of waste…. any other rule would deter corporate boards from the optimal rational acceptance of risk." Similarly, the Court accepted that "legal, if risky, actions that are within management's discretion to pursue are not 'red flags' that would put a board on notice of unlawful conduct."

The decision also contains a significant discussion of director duties in supervising "risky" employee conduct. The Court refrained from reading into Delaware's *Caremark* doctrine — the doctrine that requires boards to put systems in place to "monitor fraud and illegal activity" — a further duty to "monitor business risk." Because determining "the trade-off between risk and return" is at the heart of business judgment, the courts should avoid second-guessing "a board's determination of the appropriate amount of risk." The Court cautioned against expanding the frontiers of liability in this area, since to do so could gut the Delaware statute protecting directors from personal liability for breaches of the duty of care, "and could potentially chill the [ability of Delaware companies to obtain the] service of qualified directors." In sum, "oversight duties under Delaware law are not designed to subject directors … to personal liability for failure to predict the future and to properly evaluate business risk."

The *Goldman Sachs* decision stands as a profound and persuasive restatement of fundamental principles of corporate law, and should give directors confidence that well-informed business decision-making in the realm of executive and employee compensation remains strongly protected by the business judgment rule.