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"Are there legal limits on an executive's attempts to influence … compensation decisions affecting her?"

CEOs Beware: Don't Overreach in Comp Negotiations

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The ongoing *Disney* litigation has focused attention on the proper role of board members in setting and approving executive compensation. But what about the role of the executive in that process? May she bargain hard? Are there legal limits on an executive's attempts to influence board members on compensation decisions affecting her? A recent court decision helps answer these questions and should serve as a warning to CEOs and other high level executives owing a fiduciary duty to their companies.

In the court decision, *Official Committee of Unsecured Creditors of Integrated Health Services, Inc., v. Elkins*, 2004 WL 1949290 (Del. Ch. 2004), the Delaware Court of Chancery applied principles established in *In Re The Walt Disney Co. Derivative Litigation,* 825 A.2d 275 (Del Ch. 2003), to claims that a CEO acted improperly in influencing his company's board of directors in setting the CEO's compensation. It did so in the context of a motion to dismiss claims brought by an unsecured creditors' committee of the bankrupt employer. Because it was considering a motion to dismiss, the court assumed that the facts alleged by the creditors' committee were true. The creditors' committee argued that the founder and CEO of the company breached his fiduciary duties of loyalty and good faith to the company by obtaining certain compensation arrangements without regard to the best interests of the company, and by using his various positions at the company to exert improper influence over other members of the board (the CEO himself was a board member) and over the board's compensation consultant.

The creditor's committee alleged, in essence, that the board blindly approved whatever compensation the CEO requested. That compensation allegedly amounted to at least $40 million over a period of about five years. During this time, the company's stock fell in value and the company ultimately declared bankruptcy.

The court's analysis of the propriety of the board's actions is of note, but the more important lesson may be the guidance the decision offers to CEOs and other very high level executives. The court summarized the special rules which apply to CEOs and other employees with a fiduciary obligation to their companies as follows:

> In general, employees negotiating employment agreements with their employers have the right to seek an agreement containing the best terms possible for themselves. However, once an employee becomes a fiduciary of an entity, he has a duty to negotiate further compensation agreements "honestly and in

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> good faith so as not to advantage himself at the expense of the [entity's] shareholders. *Walt Disney Co. Deriv. Litig.*, 825 A.2d at 290. This requirement does not prevent fiduciaries from negotiating their own employment agreements so long as such negotiations are "*performed in an adversarial and arms-length manner.*" *Id.*

The court found that the creditors' committee's allegations, if true, could indicate that the CEO had breached his duty of loyalty and improperly engaged in a self-interested transaction. In reaching this conclusion, the court relied on a list of alleged facts concerning the CEO's claimed control over the board. In particular, the creditors' committee asserted that the CEO set out agendas for the board and compensation committee meetings; attended those meetings; spoke with directors outside of the meetings; negotiated his compensation packages with the board and compensation committee; and spoke with the board's compensation consultant. The court said taken individually none of these actions would be enough to show a breach of the CEO's duty of loyalty. However, these allegations, when coupled with allegations that the CEO reviewed and revised every draft of the compensation consultant's reports before they were submitted to the board; the CEO exerted pressure on the compensation consultant to justify the CEO's compensation; a letter the CEO wrote to the board inaccurately stated facts as to what the compensation committee had previously approved in terms of forgiveness of loans to the CEO (much of the compensation at issue concerned loans and their forgiveness); the CEO caused the company to disburse funds to him without corporate authority; the CEO insisted on a loan program in anticipation of an outside lender eliminating the company's use of its credit agreement to provide loans to employees; and the CEO insisted on extending a loan forgiveness program to all of his loans, notwithstanding opposition by the compensation consultant; suggest that the CEO "may have breached his fiduciary duties by engaging in a self-interested transaction."

The court rejected the CEO's argument that compensation committee or board approval eliminated any breach of the duty of loyalty. Instead, if the CEO in bad faith manipulated the process of the compensation committee or board approval itself, the CEO could not benefit from the decisions reached through that process.

Lessons. The *Elkins* decision, though only a ruling on a motion to dismiss, is a warning to CEOs and other high level executives having a fiduciary duty to their companies. To avoid committing a breach of his or her duty of loyalty, a CEO (or other executive with a fiduciary obligation to the company) should negotiate his or her compensation in an arms-length manner, in good faith, and not in an attempt to advantage the CEO at the expense of the company's shareholders.

It is one thing to state these principles and another to know how they should apply in particular factual circumstances. The bottom line is probably that a CEO will not breach his or her duty of loyalty to the company in seeking compensation if (a) the compensation is within a reasonable range, given the CEO's and company's performance, (b) the CEO does not dominate the board, but instead the board and compensation committee act in a disinterested and independent fashion, and (c) the CEO keeps his or her distance from board and compensation committee deliberations on compensation, and does not individually lobby members of the board, its compensation committee, or their advisors on issues relating to the CEO's compensation, but instead discusses compensation only in a formal and open matter with the board, compensation committee, or other party appointed to negotiate with the CEO.

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