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DIRECTOR COMPENSATION

# Director Compensation in the Crosshairs of the Delaware Courts

BY DOREEN E. LILIENFELD

In the wake of the financial crisis, corporate governance issues related to executive compensation became the subject of intense scrutiny by regulators, stockholders and their advisers. In this highly charged environment, less attention had been paid to non-employee director compensation. The Delaware Chancery Court now appears willing to step into this void with a series of decisions limiting the extent to which the business judgment rule protects directors charged with determining their own compensation.

In *Calma v. Templeton*, 114 A.3d 563 (Del. Ch. 2015) (the ''Citrix Case''), Chancellor Andre G. Bouchard ruled that committee members who approve their own compensation will not be able to rely on the affirmative defense of stockholder ratification if the stockholder-approved equity plan pursuant to which their grants were made does not set forth either the specific compensation to be granted to non-employee directors, or meaningful ''ceilings'' on potential compensation (13 CARE 953, 5/8/15).

Almost immediately following the Citrix Case, stockholders began testing the extent to which the entire fairness standard limits directors' discretion with respect to determinations of their own compensation. In *Binning v. Ogunlesi*, C.A. No. 11118-CB (Del. Ch. complaint filed June 9, 2015) (the ''Goldman Case''), a stockholder filed suit against the directors of Goldman Sachs Group Inc. (Goldman) alleging breach of their fiduciary duty of loyalty by awarding non-employee directors fees that exceeded the value of the average fees paid to directors in Goldman's peer group.

Most recently, in *Espinoza v. Zuckerberg*, CA No. 9745-CB (Del. Ch. Oct. 28, 2015) (the ''Facebook Case''), Chancellor Bouchard ruled that stockholder ratification of a transaction that was approved by an interested board of directors must be accomplished formally through a vote at a stockholders' meeting, or by written consent in compliance with § 228 of the Delaware General Corporation Law (DGCL) (57 CARE 57, 10/29/15).

This article discusses all three cases, and provides suggestions on how compensation committees can best protect themselves from similar stockholder lawsuits.

## The Citrix Case

In 2005, the stockholders of Citrix Systems Inc. (Citrix) approved the company's 2005 Equity Incentive Plan (EIP), which set forth an aggregate limit on the number of shares that could be granted under the EIP, and an annual limit on the number of shares that could be awarded to any participant (including directors, officers, employees and consultants). The annual limit was set at one million shares and there were no sub-limits based on the participant's position at the company. At the time the complaint was filed, one million shares of Citrix stock was worth approximately $55 million, and the plaintiff argued that this exorbitant dollar value rendered the cap ''specious.''

Under the terms of the EIP, the compensation committee (or the full board) had discretion to grant awards, subject only to the limitations described above. Thus, the committee could determine how many awards to make, and to whom to make them. Pursuant to a practice previously disclosed to stockholders, direc-

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tor compensation consisted of restricted stock units (RSUs), options and cash. Beginning in 2011, however, the compensation committee recommended, and the board approved, eliminating options from the mix and increasing the number of RSUs that would be granted each year to 4,000 from 3,333. This resulted in directors receiving approximately $100,000 more in compensation than they had received in 2010. In April of 2014, a stockholder filed a derivative action on behalf of the company against the directors alleging breach of their fiduciary duties by approving and/or receiving the awards in 2011, 2012 and 2013. The directors, moving to dismiss the case, argued that their compensation was in line with the compensation of the 14 companies that Citrix identified as its peers. The plaintiff, on the other hand, asserted that only five of those companies were truly peers of Citrix.

Chancellor Bouchard held that, because the three members of the compensation committee that approved the RSU awards also received RSUs, the approval of the awards was a conflicted transaction that enabled the plaintiff to rebut the business judgment standard of review. This would render their decision subject to the entire fairness standard of review, which requires the directors to establish that the transaction was the product of both fair dealing and fair price, unless the directors could assert the affirmative defense of stockholder ratification. If the ratification defense were established, the business judgment rule would continue to apply and plaintiffs would have the burden of showing that the committee's decision cannot be attributed to any rational business purpose (which, as the court points out, is the same as the standard for waste under Delaware law).

**Going forward, companies will need to balance the risk of director compensation being analyzed under the "entire fairness" standard with the loss of flexibility that arises from including meaningful or specific limits on the potential awards.**

To establish the ratification defense, defendants relied on the 2005 stockholder approval of the EIP, and the fact that all awards being challenged were validly made pursuant to the terms of the EIP. As stated above, however, the only limit on compensation under the EIP provided that non-employee directors, like all EIP participants, could receive up to one million shares per calendar year. Citing to the 2012 opinion in *Seinfeld v. Slager*, C.A. No. 6462-VCG (Del. Ch. June 29, 2012) (the "Slager Case") (10 CARE 674, 7/6/12), Chancellor Bouchard held that, because the EIP did not include any specific or meaningful limits on the compensation to be granted to non-employee directors, the Citrix stockholders never approved "any action bearing specifically on the magnitude of compensation for the company's non-employee directors." As a result, the directors failed to satisfy their burden of establishing stockholder ratification and the transaction would be examined using the entire fairness standard. Further, because the plaintiffs raised meaningful questions as to whether the directors utilized the proper peer group for determining the appropriate compensation, the Chancery Court held that it was possible that the awards were not "entirely fair," and the directors' motion to dismiss was denied.

## The Goldman Case

Similar to the directors at Citrix, the non-employee directors at Goldman were compensated with a fixed number of RSUs that, during the years of 2012 through 2014, was set at 3,000 per year. The 2012 compensation was paid pursuant to Goldman's 2003 Amended and Restated Stock Incentive Plan (the "2003 SIP"), and the 2013 and 2014 compensation was paid pursuant to Goldman's Amended and Restated 2013 Stock Incentive Plan (the "2013 SIP") (together, the "SIPs"). The 2003 SIP provided for a per-participant limit of 24.75 million shares which had a value of approximately $2.8 billion at the time the complaint was filed. The 2013 SIP limited the total number of shares available for grant to 60 million (with no per-participant limit). Each SIP had been approved by Goldman's stockholders and contained language stating that "no member of the Board or the Committee . . . shall have any liability to any person . . . for any action taken or omitted to be taken or any determination made in good faith with respect to the Plan or any Award." Beginning in 2015, Goldman shifted from compensating its non-employee directors with a fixed number of RSUs to an amount of RSUs having a fixed-dollar value of $500,000.

The compensation committee at Goldman consisted of all of the non-employee directors, and, as the complaint alleges, the board did not seek stockholder approval of any specific limits on the amount of compensation the non-employee directors could award themselves.[1] Therefore, the plaintiff argued, the directors have the burden to prove the entire fairness of their compensation. In arguing that the compensation was not entirely fair, the plaintiff points to the fact that, during the three years in question, the directors earned nearly $240,000 more on average than the directors in Goldman's self-selected peer group, while Goldman's stock price moved at the same pace as those companies' stock prices.[2] The defendants, however, in their motion to dismiss, argue that the plaintiff failed to plead any facts that would illustrate that the non-employee director compensation was the result of unfair dealing or unfair price, and merely included conclusory statements that the compensation was excessive. Therefore, the defendants argue, unlike in the Citrix Case, in which the plaintiff alleged that Citrix's stock price both lagged its peers and dropped almost immediately after the awards were made, the plaintiff offered no facts that would warrant continuing the litigation past the procedural

[1] The complaint alleges that the compensation committee set the non-employee director compensation but the defendants, in their opening brief in support of their motion to dismiss, state that it was Goldman's Corporate Governance, Nominating and Public Responsibilities Committee.

[2] Although the plaintiff did not concede that Goldman utilized an appropriate peer group, it did not challenge the composition of that peer group.

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stage of a motion to dismiss.[3] This case is presently pending; the plaintiff must respond to the defendants' motion to dismiss by Dec. 21.

## The Facebook Case

While the Citrix, Slager and Goldman Cases focus on the content of the stockholder approval, the Facebook Case focuses on the process by which stockholders express their approval of a corporate action for purposes of ratifying the action. In 2013, the board of directors of Facebook Inc. (Facebook) approved compensation for its non-employee directors that included an RSU grant with a value of $300,000 per year (based on the stock price in August, after the second quarter financial results for 2013 were released).[4] In its complaint, the plaintiff alleges that the RSUs, along with the cash retainers paid to the directors, constituted excessive compensation. Because six of the eight members of Facebook's board received RSUs, and were therefore interested in the transaction, the plaintiff asserted that the entire fairness standard should apply.

Following the filing of the action, Facebook's controlling stockholder, Mark Zuckerberg, expressed his approval of the non-employee directors' compensation in a deposition and affidavit. The defendants argued that this resulted in a valid stockholder ratification of the 2013 non-employee director compensation, and, therefore, the business judgment rule should apply. Looking to existing case law on stockholder ratification, as well as the policies underlying the DGCL, the court determined, in a case of first impression, that valid stockholder ratification must be accomplished formally through a vote at a stockholders' meeting, or by written consent in compliance with § 228 of the DGCL. As a result, Zuckerberg's informal approval of the 2013 non-employee director compensation did not constitute valid stockholder ratification and the board's decision would be subject to entire fairness review. Because the directors, at that stage of the proceedings, had yet to demonstrate that the transaction was the product of fair dealing and fair price, the court denied the directors' motion for summary judgment and, absent settlement or reversal of the summary judgment opinion,[5] the case will move to trial and the burden will be on the directors to prove that the compensation was entirely fair to the company.[6]

[3] The defendants also argued that the entire fairness standard should not apply, and the Chancery Court should apply the good faith standard provided in each SIP.

[4] The fair value on the November grant date was $387,874.

[5] On Nov. 20, the Chancery Court granted defendants' application for certification of an interlocutory appeal of the Chancery Court's decision to the Delaware Supreme Court, seeking to establish entire fairness as the standard of review.

[6] With respect to compensation paid to a company's controlling stockholder(s), the Chancery Court, in *Friedman v. Dolan*, C.A. No. 9425-VCN (Del Ch. June 30) (Letter Op.), ruled that the business judgment rule would apply absent additional evidence that the directors were beholden to the controlling party (13 CARE 1509, 7/3/15). ''[T]his Court hesitates to endorse the principle that every controlled company . . . must demonstrate the entire fairness of its executive compensation in court whenever questioned by a shareholder.'' *Friedman* at 18.

## Going Forward

Going forward, companies will need to balance the risk of director compensation being analyzed under the ''entire fairness'' standard with the loss of flexibility that arises from including meaningful or specific limits on the potential awards and the costs and benefits of obtaining stockholder ratification. Companies that decide to retain maximum flexibility and not include meaningful or specific limits must ensure they will be able to defend the compensation if it is examined under the ''entire fairness'' standard. This may require greater scrutiny of the selected peer group for benchmarking, and granting director compensation that is reasonable in light of those benchmarks.

Companies that amend their director compensation programs to include meaningful or specific limits should ensure the limits take one of the following forms:

- *A Meaningful Annual Limit*. Although the Chancery Court did not establish what constitutes a ''meaningful'' limit on director compensation, both the Citrix Case and the Slager Case provide examples of what does *not* constitute a meaningful individual limit. In the Citrix Case, directors were eligible for up to $55 million in compensation (based on the stock price at the time the complaint was filed), and, in the Slager Case, directors were eligible for up to $22 million in compensation (based on the stock price at the time the complaint was filed). To the extent a company decides to adopt a limit on director compensation, it should consider describing the limit as a maximum dollar amount, rather than a maximum share amount. This will enable the company to avoid having to reconsider whether the limit is still meaningful if the price of shares increases.

- *Specific Limits*. Additional certainty can be provided to a company that provides specific limits or formulas in its compensation plan. As a result, stockholder approval of the plan will also constitute stockholder approval of the specific awards to be granted each year. Companies that take this approach, however, will limit the flexibility they currently retain when setting director compensation.

In addition, if the Facebook Case stands, in order to constitute valid stockholder ratification, companies should be aware that the approval must conform to the formal requirements of the DGCL. Companies will not be able to rely on the informal acquiescence of a controlling stockholder, nor, as has been suggested by some, the results of a non-binding say-on-director pay vote. Further, although both the Slager Case and the Citrix Case focused solely on the equity portion of the non-employee director compensation, the Chancery Court in the Facebook Case also reviewed the cash retainer Facebook paid to its non-employee directors. This discussion by the court serves as a subtle reminder that companies seeking stockholder ratification of non-employee director compensation should consider including cash compensation in the ratification, as well.