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GUEST COMMENTARY

ATTRACTING A STRONG BOARD

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In the wake of the recent financial crisis and earlier accounting scandals, investors in public biotech companies increasingly have focused their attention on corporate governance and boardroom underperformance. As a result, the composition of a company's board of directors has become an increasingly important factor for investors in deciding whether to buy, hold or sell stock. At the same time, stricter requirements imposed by government regulators, a higher level of scrutiny by proxy advisory firms and an increasingly litigious plaintiff's bar are making it harder to attract strong board members who meet the tests of independence and experience.

Biotech companies can take several steps to make their boards more attractive to top-tier candidates, including providing access to key management and advisors, and ensuring that board compensation policies are designed in light of recent court rulings.

DIMINISHED POOL OF CANDIDATES

The pool of individuals who are eligible to serve on the boards of publicly listed U.S. companies has diminished as regulators and proxy advisory services have adopted restrictive standards. For instance, the NYSE and NASDAQ both require a majority of their listed company boards to be independent. The SEC and the exchanges also require members of audit committees and compensation committees to be independent (with independence standards beyond what is required for board members, generally). Both exchanges require boards of directors to affirmatively determine whether or not each director is independent, and this review includes evaluating whether the director has a relationship with the company or is an officer, partner or shareholder of a company that has a relationship with the company. In addition, both exchanges list specific relationships that can prohibit a finding of independence.

Further, this past year, Institutional Shareholder Services Inc. (ISS) and Glass Lewis & Co. LLC, which make recommendations to institutional investors on corporate governance matters, have imposed new limits on "over boarding," or the number of boards on which a director can serve. Beginning in 2017, both firms will recommend a vote against a director who sits on more than five public company boards. ISS will also recommend a vote against a director who is a CEO of a public company and sits on the boards of more than two public companies besides his or her own. The new Glass Lewis policy will recommend a vote against a director who is an executive officer of a public company and serves on more than two public company boards.

NO COMPANY IS IMMUNE TO THE POSSIBILITY THAT A PROBLEM WILL TURN INTO A CRISIS.

The result is a situation in which biotechs must compete for a dwindling number of candidates who have the requisite experience in the biotech industry to be an effective board member, can meet the standards for independence and are not overcommitted to other boards.

THE RELUCTANT CANDIDATE

Among the candidates who clear the regulatory hurdles, some may be reluctant to join boards out of fear that this once-coveted position can become a drain on their time, and damaging to both their reputation and their finances.

Directors at public biotech companies are well aware that they are within the crosshairs of a plaintiff's bar with an itchy trigger-finger. Directors of publicly traded biotech companies organized under the laws of the state of Delaware are subject to fiduciary duties that, if breached, can subject the directors to personal liability. Shareholders often file lawsuits after stock prices drop precipitously, even when the cause was totally out of the control of the company, such as an adverse decision from FDA or one of its advisory panels. Although these suits generally get settled, and insurance or the company covers the directors' legal fees or potential damages, there is still a risk that directors may have to reach into their own pockets to satisfy certain asserted claims.

Even if the lawsuit settles and the director does not have to pay any monetary damages, the settlement might not come until after a lengthy and public lawsuit in which the director may have gone through a burdensome deposition process.

Although these lawsuits cannot be avoided, there are steps companies can take to assure potential directors that they will be provided with the tools and resources to successfully defend against a breach of fiduciary duty accusation.

The Delaware courts will ordinarily defer to the business judgment rule, which presumes that the directors acted on an informed basis, in good faith and in the honest belief that their action was in the company's best interests. Therefore, absent fraud, self-dealing or abuse of discretion, the courts will generally sustain directors' decisions as a proper exercise of their discretion if the directors have demonstrated due care in making an informed judgment for a rational business purpose.

Providing directors with regular access to the company's CEO, key management, legal counsel, auditors and outside advisors increases the likelihood that a court would sustain the directors' decisions under the business judgment rule. Companies also should provide the board with information early enough to be able to make decisions. In addition, the board should have free access to the company's outside advisors to assist the board in fulfilling its responsibilities.

DIRECTOR COMPENSATION

Ensuring that directors are protected by the business judgment standard also requires shareholder ratification of non-employee director compensation if that compensation was determined by the non-employee directors themselves.

The practice in the biotech industry is to provide a significant part of non-employee director compensation in the form of equity. For publicly listed biopharmaceutical companies, these equity awards are granted pursuant to a shareholder-approved compensation plan. Oftentimes, these plans provide for a maximum number of shares that each non-employee director may receive annually. The compensation or another committee then determines the actual number of shares that each non-employee director will receive, with the value of the awards determined by the share price at the time of grant.

For publicly listed companies in a buoyant stock market, a rapid rise in share price can mean shareholders, including non-employee directors, may receive many thousands of additional dollars than projected at the start of a year. This may give other shareholders occasion to question the fairness of the non-employee directors' compensation, prompting them to challenge their legality.

Until recently, most companies (and their directors) assumed that shareholder approval of a compensation plan constituted ratification of the board's director compensation decision because of the annual limit contained in the plan. A series of cases in the Delaware Chancery Courts, however, have held that shareholder ratification will not be valid unless the company's equity plan either sets forth the specific compensation to be granted to non-employee directors, or sets meaningful "ceilings" on potential compensation. Further, per the recent case against Facebook, that shareholder ratification needs to be accomplished formally either through a vote at a shareholders' meeting, or by a written consent.

Absent formal shareholder ratification, directors' decisions would be subject to the "entire fairness" standard if the compensation is challenged rather than the business judgment rule. This is a more difficult hurdle than the business judgment standard, and may often lead companies to settle these claims with plaintiff's counsel.

In addition to protecting directors via shareholder ratification of non-employee director compensation, companies should assure their director candidates that these cases will not have an effect on the level of compensation that the directors will earn, and the directors will still be paid at levels commensurate with directors serving on boards of the company's peer group.

CRISIS MANAGEMENT

A final piece of preparedness that can give comfort to director candidates is having a crisis management plan. No company is immune to the possibility that a problem will turn into a crisis. Smaller biotechs often lack the staff and capital resources to plan for or weather the storm that a crisis might bring, and are therefore at a heightened risk of events that could spin out of control and be memorialized and disseminated through the internet.

Class-action lawyers will be ready to pounce on a company or its board for allegedly failing to recognize and address potential risks associated with the firm's operations. Further, failure of risk oversight can lead to a negative recommendation by shareholder advisory groups in voting on director elections.

To protect directors from these scenarios, a company should ensure its board is knowledgeable about the potential risks facing its business and operations, and should brief the board on its crisis management plans. Further, counsel should be included on internal and external communications concerning the plan so as to avoid plaintiff's counsel exploiting any company weaknesses that might be exposed by the crisis management plan. bc

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