Ignore the Delaware director-compensation cases at your peril

To the Editor:
Recent cases in the Delaware Chancery Court have important ramifications for the way companies in the United States provide remuneration to their nonemployee directors. Public biotech companies should take note. The court clarified that shareholder-approved compensation plans may provide insufficient ratification for compensation committees' decisions on the maximum number of shares that they may award each nonemployee director in a given year. To successfully defend legal challenges against such compensation committee decisions, biopharmaceutical companies must make greater efforts to obtain the necessary approvals from stockholders.

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

In two cases that came before the Delaware Chancery Court last year, and one case that came before the Court in 2012, plaintiffs' lawyers challenged the validity of the shareholder ratification of compensation awarded to nonemployee directors of several public companies. What can be gleaned from these cases, including the Facebook (Menlo Park, CA, USA) case, is that shareholder approval of an equity compensation plan does not serve as shareholder ratification of nonemployee director compensation awards when the equity plans either do not set forth the specific compensation to be granted to nonemployee directors or set meaningful "ceilings" on potential compensation. Furthermore, the stockholder ratification must be accomplished formally either through a vote at a stockholders' meeting or by formal written consent.

These cases are particularly relevant to biotech companies because of the potential volatility in their share prices; indeed, the pop in an equity award's value to nonemployee directors following the release of positive news (e.g., a positive clinical trial or an attractive collaboration with big pharma) may mean legal challenges of compensation decisions become much more commonplace in biotech.

Publicly listed biopharmaceutical companies compensate their nonemployee directors with equity awards that are granted in a shareholder-approved compensation plan. Often times, these plans provide for a maximum number of shares that each nonemployee director may receive annually. The compensation committee then determines the actual number of shares that each nonemployee director will receive, with the value of the awards determined by the share price at the time of grant. Until the recent cases in Delaware, most companies (and their directors) assumed that shareholder approval of a compensation plan constituted ratification of the compensation committee's final decision due to the annual limit contained in the plan. Because nonemployee directors who approve their own compensation are not "disinterested" in the transaction, shareholder ratification is necessary to ensure that the directors will be protected by the business judgment rule in the event their awards are challenged.

The business judgment rule presumes that independent and disinterested directors act in the best interests of the company. If a board's decision is challenged, plaintiffs must show that the board's decision cannot be attributed to any rational business purpose. As a result, most challenges to board actions are dismissed. When directors have an interest in the challenged transaction, plaintiffs can rebut the business judgment standard. This makes the board's decision subject to the "entire fairness" standard of review. This standard places the burden on the directors to establish that the transaction was the product of both fair dealing and fair price. This is a more difficult hurdle and may often lead companies to settle these claims with plaintiffs' counsel.

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 do 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 by the compensation committee and the board of directors of the selected peer group for benchmarking, of the timing of the awards to avoid issuing awards in anticipation of the release of positive news, and of granting director compensation that is reasonable in light of those benchmarks. An additional defense would be shareholder ratification of the interested directors' decision.

Companies that amend their director compensation programs to include meaningful or specific limits should ensure the limits take one of the following two forms. First, companies should consider a meaningful annual limit. Although the Delaware Court did not establish what constitutes a "meaningful" limit on director compensation, the cases against Citrix (Fort Lauderdale, FL, USA) and Republic Services (Phoenix, AZ, USA) provide examples of what does not constitute a meaningful individual limit. To the extent a biopharmaceutical company decides to adopt a limit on annual 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 in the

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event of substantial share price increases.

Second, additional certainty can be provided to a company if specific limits or formulas are established in its compensation plan. As a result, stockholder approval of the plan will also constitute stockholder approval of the caps or grant formulas. Companies that take this approach, however, will limit the flexibility they currently retain when setting director compensation.

In addition, in light of the Facebook case, companies should ensure shareholder approval of actions is formalized. Companies will not be able to rely on the informal acquiescence of a controlling stockholder to an action. Furthermore, in Facebook, the court reviewed the cash retainer paid to nonemployee directors (in addition to the equity compensation component). This serves as a subtle reminder that companies seeking stockholder ratification of nonemployee director compensation should consider having cash compensation ratified as well.

ACKNOWLEDGMENTS
The authors would like to thank D. Ling and M. Behrens for their contributions to this article. The views expressed here are the authors' and do not necessarily represent the views of the partners of Shearman & Sterling or the firm as a whole.

COMPETING FINANCIAL INTERESTS
The authors declare no competing financial interests.

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