# Delaware Court of Chancery Subjects Non-Employee Director Compensation to the "Entire Fairness" Standard

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On April 30, 2015, the Delaware Court of Chancery held for the second time in three years that a decision by a board of directors or a board's compensation committee to award equity to non-employee directors as part of their annual compensation constituted a self-interested transaction and, when challenged in a stockholder derivative action, that (a) stockholder demand was excused and (b) the decision would be reviewed under the heightened "entire fairness" standard. This holding comes despite the fact that the equity compensation plan in question, which included a per-person limit on grants, was previously approved by the company's stockholders.

At issue in the case were restricted stock unit (RSU) grants to eight non-employee directors of Citrix Systems, Inc., which had been made under a stockholder-approved omnibus equity incentive plan that had included a limit on the number of shares that could be granted to any one individual in a given year.

The Court concluded that stockholder approval of "a compensation plan with multiple classes of beneficiaries and a single generic limit on the amount of compensation" did not satisfy the affirmative defense of stockholder ratification, which would have precluded the "entire fairness" standard of review (and instead subjected the decision to review under a corporate waste standard), because the company did not seek or obtain stockholder approval of "any action *bearing specifically on the magnitude of compensation to be paid to its non-employee directors*." (emphasis in original)

The case, ***Calma v. Templeton et al.***, C.A. No. 9579-CB, is a sobering reminder for Delaware companies – as well as companies incorporated in the many jurisdictions that treat Delaware corporate law as persuasive authority – that non-employee director compensation may be susceptible to challenge under the heightened "entire fairness" standard, unless stockholders have approved the actual amount, or "meaningful" and specific limits on the amount, of compensation to be paid to directors.

While much of the case law to date has dealt with equity awards, the analysis in this case could presumably apply to cash compensation as well.

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The case involves a stockholder derivative suit brought against Citrix and its non-employee directors. The facts are fairly straightforward:

- Citrix had a stockholder-approved equity incentive plan under which its compensation committee may make awards to employees, directors and consultants.
- The plan included an aggregate share limit and a per-person limit (including for non-employee directors), providing that no individual may receive awards covering more than one million shares in any given year. Based on Citrix's stock price at the time the claim was filed, one million shares had a value of $55 million.
- In 2010, consistent with the board's previously announced director compensation practice, the compensation committee granted RSUs with a grant date fair value of $143,852 and stock options with a grant date fair value of $101,116, to non-employee directors. The directors also received cash compensation of between $43,750 and $67,072, bringing their total 2010 compensation to between $288,718 and $312,040.

- Beginning in 2011, the board changed its director compensation practice, making an annual grant of 4,000 RSUs for returning non-employee directors and a one-time grant of 10,000 RSUs for new non-employee directors. Non-employee directors also received an annual cash amount, but no further stock options. As a result of these changes, total 2011 compensation increased by approximately $100,000 per director, as compared to their compensation for 2010.
- The suit was brought as a stockholder derivative action, alleging that the RSU grants for 2011, 2012 and 2013 were excessive and constituted a breach of fiduciary duty, corporate waste and unjust enrichment.

Citrix and its directors moved to dismiss the suit on grounds that, among other things, the plaintiff had failed to make a pre-filing demand on the Citrix board and on the basis that the RSU grants had been ratified in advance through stockholder approval of the equity incentive plan.

In an opinion written by Chancellor Bouchard surveying over 60 years of Delaware case law involving non-employee director compensation, the Court excused pre-filing demand, finding that the plaintiff was entitled to a presumption that demand was futile because a majority of the board's directors had received the awards in question and were therefore interested in the challenged transactions. Moreover, based on this finding and the absence of meaningful limits on the awards under the plan, the Court concluded that the defendants would bear the burden of proving "to the *court's* satisfaction that the [RSU grants were] the product of both fair dealing *and* fair price" (citing another case, but emphasis in the *Citrix* opinion) – the "entire fairness" standard of review.

The Court rejected the argument that approval of the compensation plan by stockholders constituted ratification of the compensation committee's authority to make the challenged grants, which, if accepted by the Court, would have subjected the RSU grants to review under a corporate waste standard (which is very difficult for plaintiffs to satisfy). The Court distinguished the case from prior cases where director equity grants were subject to a formula or meaningful maximum limit set in a plan approved by stockholders. The Court concluded that the one million share annual cap in the plan did not serve as a basis for valid stockholder approval, with focus on the fact that one million shares equated to $55 million.

In response to the company's assertion that its director compensation was in line with that of the peer group reflected in its proxy statement, the Court concluded that the appropriateness of a peer group that included companies "with considerably higher market capitalizations, revenue, and net income," such as Amazon, Facebook and Google, was a factual question for trial.

We note that the decision ultimately denied, in part, the defendants' motion to dismiss, and thus the case will proceed forward on the merits.

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The outcome in the *Citrix* case is similar to the 2012 Delaware Court of Chancery's decision in ***Seinfeld v. Slager et al.****,* C.A. No. 6462-VCG, a stockholder derivative suit focusing on executive and director compensation, in which the court dismissed all claims against the defendants except for a claim that certain director equity awards constituted corporate waste. Vice Chancellor Glasscock wrote:

> "Here, even though the stockholders approved the plan, the Defendant Directors are interested in self-dealing transactions . . . . The Stock Plan lacks sufficient definition to afford the Defendant Directors protection under the business judgment rule. The sufficiency of definition that anoints a stockholder-approved option or bonus plan with business judgment rule protection exists on a continuum. Though the stockholders approved this plan, there must be some *meaningful* limit imposed by the stockholders on the Board for the plan to . . . receive the blessing of the business judgment rule . . . . A stockholder-approved *carte blanche* to the directors is insufficient. The more definite a plan, the more likely that a board's compensation decision will be labeled disinterested and qualify for protection under the business judgment rule. If a board is free to use its absolute

> discretion under even a stockholder-approved plan, with little guidance as to the *total* pay that can be awarded, a board will ultimately have to show that the transaction is entirely fair." (emphasis in original)

It may have been tempting to view *Seinfeld* as anomalous, since the directors' fees in that case exceeded the customary range and the case presented other allegations that the board had been overly generous in matters of compensation. Many hoped that a board could substantially insulate itself by supporting its non-employee director equity grants with an independent analysis, including taking into account the comparative data of peers that had been rigorously selected. After all, boards have always set their own compensation and this focus on the equity component of director pay is a relatively recent development.

The *Seinfeld* and *Citrix* decisions cast a shadow, and they do not stand alone:

- In the June 2014 case of ***Cambridge Retirement System v. Bosnjak et al.***, C.A. No. 9178-CB, a stockholder-plaintiff challenged two components of compensation awarded to the non-employee directors of Unilife Corp., a public company in some financial distress: (1) equity awards, which were approved by stockholders, and (2) cash compensation, which was granted without the benefit of stockholder approval. The plaintiff alleged that the amounts were excessive compared to Unilife's revenue and to similarly sized companies in its sector and, therefore, constituted corporate waste. The plaintiff further alleged that the directors' approval of their compensation constituted a breach of fiduciary duty. While Chancellor Bouchard granted the defendants' motion to dismiss with respect to the fiduciary duty claim on the equity awards, finding them to have been adequately approved by stockholders and therefore protected by the business judgment rule, the Chancellor refused to dismiss the fiduciary duty claim related to cash compensation, in part due to ambiguity in Unilife's proxy disclosure on director pay.
- In June 2014, a derivative action was filed in the Delaware Court of Chancery on behalf of Facebook, Inc., alleging that the company's equity compensation plan allowed the directors unfettered discretion (other than a 2.5 million share per-participant cap, which, based on the stock price at the time of the complaint, was $145 million per person) to set their own compensation and that the board had awarded excessive compensation to directors. Although the board had never made equity awards to directors in the magnitude that was theoretically permissible, the complaint alleged that the average amount paid to directors in 2014 was excessive relative to the company's peers. This lawsuit, which remains pending, alleged breaches of fiduciary duty, waste of corporate assets and unjust enrichment.
- In October 2014, a derivative action was filed in the Delaware Court of Chancery on behalf of Celgene Corporation. In this case, the stockholder-plaintiff argued that, while non-employee director compensation of the company's peers was pegged to a flat dollar amount or is adjusted to reflect the rise in stock prices, the equity compensation of Celgene's non-employee directors is denominated in shares and had therefore increased significantly in recent years. As in the *Facebook* lawsuit, the *Celgene* complaint alleged breaches of fiduciary duty, waste of corporate assets and unjust enrichment and remains pending.

Although boards that act reasonably and thoughtfully in setting their compensation – using appropriately rigorous peer group data and, where appropriate, outside advisers – should be able to ultimately prevail over specious claims, the *Seinfeld* and *Citrix* decisions identify only one certain path to eliminate these claims at the initial pleading stage: a meaningful stockholder-approved limit on non-employee director awards.

**What Should Companies Do?**

A company planning to take to stockholders a compensation plan in which non-employee directors participate in this coming proxy season should consider adding a meaningful individual limit on non-employee director awards or adopting a formula plan. This should, of course, continue to be weighed against the company's desire for flexibility in establishing director compensation, in light of changing circumstances.

A company considering increasing the compensation granted to non-employee directors under a plan that does not currently have a meaningful limit should consider working closely with a compensation consultant to review the proposed increase, taking into account appropriate peers and weighing the costs and benefits of obtaining stockholder approval instead of relying on peer group data alone.

A company without current plans to amend its non-employee director compensation program, or to increase director compensation under the program, should consider whether or not obtaining stockholder approval may nevertheless be desirable. A relevant factor is the comparability of the company's director compensation program to those of its peer companies.

If a company decides to take a plan to stockholders, it will be important to take into account how actual stockholders and the proxy advisory firms will assess the company's non-employee director compensation program, especially in view of ISS' new **equity plan scorecard** to evaluate equity compensation plans generally.

It is difficult to arrive at a "one size fits all" solution on this issue. Given the Delaware Court of Chancery's endorsement of stockholder-approved limits for non-employee director equity compensation, the question arises whether it would reach the same conclusion if their cash compensation were challenged and whether this entire matter could be best addressed with independent analysis and solid peer group comparisons rather than stockholder-approved limits.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.


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