Cause for concern regarding director compensation

Directors have again been given a clear message: If they set their own compensation without 'guardrails' approved by the shareholders they risk facing breach of fiduciary duty claims.

By Doug Raymond

In recent years, there have been rumblings about the risks directors face when approving their own compensation. Those rumblings, triggered by a 2012 Delaware Court of Chancery opinion, *Seinfeld v. Slager*, reverberate further following the most recent ruling on the subject. *Calma v. Templeton* closely echoes *Seinfeld* and gives directors renewed reason for concern.

In *Calma v. Templeton*, a shareholder filed suit against Citrix Systems Inc., a Delaware corporation, and its board of directors alleging that Citrix's directors had breached their fiduciary duties by awarding excessive equity compensation to the company's non-employee directors. The plaintiff further argued that these awards were self-dealing transactions because they were made by the recipient directors to themselves and so, as in *Seinfeld*, the highly burdensome entire fairness standard of review applied.

The Citrix board had granted these awards under the company's omnibus Equity Incentive Plan, which had been approved by a majority of the company's disinterested shareholders. The plan had given to the board's compensation committee, consisting solely of non-employee directors, broad discretion to grant awards to the plan's myriad potential participants, including Citrix officers, directors, employees, and advisors. The only limitation was that no single participant could receive more than 1 million shares per year, which translated to more than $55 million. The plan set no sub-limits on awards to directors.

As in earlier cases, the Citrix directors argued that the challenged awards to the non-employee directors had been ratified when the shareholders approved the plan and the decision to approve the challenged awards was therefore entitled to business judgment deference. The court disagreed.

No sanctuary

The court concluded that ratification offers no sanctuary to directors purporting to act under a "blank check" from shareholders. Because the court found that the shareholders had not been

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asked to approve any act bearing on the magnitude of non-employee director compensation, it held that the plan's approval alone could not ratify the decision to award the challenged equity grants. The court went on to note: "[s]pecifying the precise amount and form of director compensation in an equity compensation plan when it is submitted for stockholder approval 'ensure[s] integrity' in the underlying principal-agent relationship between stockholders and directors 'by making the directors suffer the ugly and enjoy the good that comes with a consistent, non-discretionary approach' to their compensation." The court further concluded that obtaining shareholder approval of director compensation on a regular basis facilitates the disclosure of inherently conflicted decisions and confers upon shareholders a meaningful role in their fiduciaries' compensation.

A RATIFICATION DEFENSE WOULD HAVE BEEN AVAILABLE IF SHAREHOLDERS HAD BEEN ASKED TO APPROVE A PLAN WITH 'MEANINGFUL' LIMITS.

Without a ratification defense, the Citrix directors could not depend on the deference afforded by the business judgment rule, but instead had to show that the awards they granted themselves were "entirely fair." This heightened level of scrutiny requires defendants to establish both that the amount of the contested awards and the process by which the directors approved them were entirely fair to the company.

As noted after *Seinfeld*, directors who set their own compensation without guardrails approved by the shareholders risk facing breach of fiduciary duty claims and the burden of demonstrating that their actions were entirely fair. As *Calma* reinforces that message, thoughtful boards will act to shield themselves and the company before litigation looms.

Boards can start by carefully reviewing their existing compensation programs and processes for approving them, preferably in consultation with a compensation consultant and experienced counsel. This will allow directors to identify and assess potential vulnerabilities, including compensation programs that may be out of step with the prevailing market, and better chart a path forward.

Boards should also consider securing the protection of the business judgment rule through shareholder action. For example, when amending or adopting new equity compensation plans, boards should consider including specific caps on director compensation for shareholder approval. In both *Seinfeld* and *Calma*, the Court acknowledged that a ratification defense would have been available if shareholders had been asked to approve a plan with "meaningful" limits, including "specific ceilings" based on the participant's specific position held and services performed.

The surest safeguard

While currently not a common practice, the surest safeguard against a legal challenge may be to secure shareholder approval of specific director compensation packages. In rejecting the Citrix directors' ratification defense, the court acknowledged that, just months before, it had credited a similar stockholder ratification defense concerning director compensation because there, unlike in *Calma*, the stockholders had approved each of the specific equity awards challenged.

Directors may also try to establish that the process used to set the compensation for the outside directors was fair by delegating that evaluation to a committee composed only of those directors who were not participating in the compensation programs — which in most companies would be the CEO, who typically is the sole management director. Because the outside directors set the compensation of managers, this approach is potentially vulnerable to accusations of mutual backscratching. However, this concern may be alleviated if this committee follows a rigorous process in assessing and determining the directors' compensation.

Finally, boards should in any event position themselves to establish, if challenged, the entire fairness of both the value of and the process for approving director compensation packages. Along these lines, boards might consult a compensation expert as well as develop a comprehensive record to support compensation decisions. While no one step will eliminate the risk of litigation, the involvement of competent consultants and a well-documented record will prove invaluable if forced to demonstrate a compensation package's entire fairness in court.

Through *Seinfeld*, and now *Calma*, the Court of Chancery has sent a clear message on director compensation. Directors will serve themselves and their companies well to listen. ■

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