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DIRECTOR LIABILITY

New Delaware Court of Chancery Opinion Provides Guidance for Director Compensation Practices

A recent opinion of the Delaware Court of Chancery, Calma v. Templeton, *has brought renewed attention to the issue of director compensation. The opinion holds that director compensation decisions may not be subject to the presumption of the business judgment rule, but may instead be reviewed under the entire fairness standard. However, it also addresses the circumstances under which stockholder ratification of director compensation decisions may restore the presumption of the business judgment rule.*

By John Mark Zeberkiewicz and Stephanie Norman

Because the amount of compensation paid to non-executive directors on an annual basis tends not to be extraordinary, directors' decisions on the matter frequently go unchallenged. When ordinary director fees are coupled with restricted stock or other equity incentive awards, however, the fees may become sufficiently substantial to precipitate a derivative suit. Despite the directors' statutory authority to fix their own compensation,[1] the decision is one on which the directors stand on "both sides" and, if challenged, may be subject to review under the entire fairness standard, making it difficult to dispense with the plaintiffs' claims at an early stage of the proceeding. A recent opinion of the Delaware Court of Chancery, *Calma v. Templeton*,[2] provides significant guidance to corporations and practitioners in structuring non-executive director compensation plans such that compensation decisions made in compliance with the plan will be more likely to avoid review under the onerous entire fairness standard.

Background

In *Calma*, the stockholder plaintiff claimed that the restricted stock units awarded to Citrix System, Inc.'s non-employee directors under its 2005 Equity Incentive Plan (Plan) were excessive. Through the suit, the plaintiff sought recovery, derivatively on behalf of Citrix, against the defendant directors under theories of breach of fiduciary duty, waste and unjust enrichment. Relying principally on a ratification defense, the defendants moved to dismiss, arguing that any

John Mark Zeberkiewicz is a director, and Stephanie Norman is an associate, at Richards, Layton & Finger, P.A., in Wilmington, DE. The views expressed herein are those of the authors and are not necessarily the views of Richards, Layton & Finger or its clients.

awards would have to be reviewed under a waste standard because stockholders had adopted the Plan.[3]

The plaintiff did not dispute that stockholders had adopted the Plan, nor did he allege that the stockholders' vote was ill-informed. Instead, he claimed that, because the Plan contained no "meaningful limit" on awards to directors, any grant made under it was a discretionary decision on the part of directors to compensate themselves and was therefore subject to entire fairness review. Although the Plan included a limit on the number of shares or RSUs that could be awarded, the total number—1 million—equated to approximately $55 million in Citrix stock at the time the action was filed.

Analysis of the Court of Chancery

Availability of the Business Judgment Rule

Noting that all of the members of Citrix's compensation committee that had approved the RSU awards were themselves recipients, the Court found that the plaintiff had rebutted the presumption of the business judgment rule.[4] Citing the Delaware Supreme Court's opinion in *Telxon v. Meyerson*,[5] the Court stated that "director self-compensation decisions are conflicted transactions that 'lie outside the business judgment rule's presumptive protection, so that, where properly challenged, the receipt of self-determined benefits is subject to an affirmative showing that the compensation arrangements are fair to the corporation.'"[6] The Court distinguished the approval of the RSU awards at issue from cases where "disinterested directors approved the compensation of other directors."[7]

In making this distinction, the Court cited to *California Public Employees Retirement Systems v. Coulter*.[8] In that case, the stockholder plaintiff challenged, among other things, the decision made by two employee-directors to reprice options held by outside directors under circumstances where the employee-directors were benefitting from a similar repricing of employee options. Explaining that the plaintiff had failed to allege sufficient facts to show that the employee-directors repriced the options of outside directors as a *quid pro quo* for the repricing of their own options, the *Coulter* Court found that the plaintiff had not alleged "that any director participated in the repricing of his own options and was therefore 'interested' as analyzed under the first prong" of the *Aronson* test for showing demand futility in a derivative action.[9]

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The *Calma* Court also cited to *Tate & Lyle v. Staley Cont'l, Inc.*,[10] which involved a challenge to the full board's decision to establish a trust to fund compensation plans that benefitted both management and non-management directors upon a change of control. Evaluating each plan that would benefit from the trust, the *Tate* Court distinguished the retirement plan approved by the full board, providing for the compensation of directors upon their retirement or upon a change of control, from the compensation packages of certain executives and other employees that were approved by the compensation committee consisting of independent directors. The *Tate* Court explained that the decision to approve the retirement plan likely would not be protected by the business judgment rule as it would, upon a change of control, "immediately benefit the same directors who proposed its adoption."[11] By contrast, the *Tate* Court explained, with respect to the officer and employee compensation packages, that "compensation decisions are generally the sole prerogative of the directors" and that such packages would likely be afforded the protection of the business judgment rule because they were approved by a committee of disinterested directors.[12] Ultimately, because the purpose of the trust was to fund all compensation plans, including the retirement plan in which the directors had a direct personal interest, the *Tate* Court held that the plaintiffs had shown a reasonable probability of success on the merits that the creation of the trust would be subject to entire fairness review.[13]

Stockholder Ratification

After describing the basic standard of review applicable in the first instance to director compensation decisions, the *Calma* Court addressed defendants' ratification argument. Undertaking a comprehensive survey of Delaware's jurisprudence on common law ratification, the Court noted that the "principle of 'ratification' stems from the law of agency," and that, "[i]n the corporate law context, stockholders (as principals) can, by majority vote, retrospectively and, at times, prospectively, act to validate and affirm the acts of the directors (as agents)."[14] The Court first described the defense of ratification as applied in *Kerbs v. California Eastern Airways, Inc.*,[15] which involved a challenge to a stockholder-approved plan that provided for option awards to be granted to named executives in specified amounts on the basis that the corporation had not received adequate consideration. Although a majority of the directors who had approved the plan were also beneficiaries under the plan, the *Kerbs* Court found that the stockholders' prior adoption of the plan, after full disclosure, would operate to ratify the consideration received by the corporation in respect of the option awards to the executives, thus requiring the plaintiff to demonstrate that the awards were fraudulent or *ultra vires* or constituted waste.[16] (Interestingly, the *Kerbs* Court found that the grants did constitute waste, as the plan contained no measures reasonably designed to ensure that the corporation received the bargained-for benefit.)[17]

The *Calma* Court also addressed the Delaware Court of Chancery's opinions in *Steiner v. Meyerson*,[18] *Lewis v. Vogelstein*[19] and *In re 3COM Corp. Shareholders Litigation*.[20] The *Calma* Court stressed that in each of these cases, the plan at issue imposed "meaningful" substantive limits on the directors' authority to grant awards. Those limits, according to the Court, were critical to the earlier findings that stockholder approval of the plan required the plaintiffs to demonstrate waste.

Ideally, non-executive director compensation would be covered in a separate plan, rather than included in an omnibus plan.

The Court next reviewed the defense of stockholder ratification as raised in *Kaufman v. Shoenberg*.[21] In that case, the plan at issue did not specify the amount of awards to be granted to specific directors, but provided that it would be administered by a committee of directors who were not entitled to receive awards under it. Because key features of the plan, including the limitations on awards and the standards governing the committee's determinations, had been disclosed to stockholders before its adoption, the stockholders' "ratification" of the plan was sufficient to restore the presumption of the business judgment rule to the committee's decisions.[22]

The Court then compared these cases to those in which the directors' ratification defense was not sufficient to restore the presumption of the business judgment rule. The Court pointed to *Sample v. Morgan*,[23] where the two non-employee directors constituting the compensation committee awarded 200,000 shares to the three management directors under a stockholder-approved incentive plan that contained no provisions specifying (or imposing a limitation on) awards to directors. The *Calma* Court's key takeaway from *Sample* was that

> because the stockholders ... merely voted in favor of the broad parameters of the plan—and had not voted in favor of any specific awards under the plan—the defendants could not show that stockholders had ratified the decision to grant all of the 200,000 shares authorized under the plan to just the three employee directors. Thus, the directors' conduct would be reviewed under ordinary principles of fiduciary duty and not limited to a waste standard.[24]

Following this line of reasoning, the *Calma* Court held that the facts before it were most analogous to those in *Seinfeld v. Slager.*[25] As with *Calma*, the plan at issue in *Slager* did not specify the amounts of awards or impose a "meaningful" limit on awards to directors. Instead, the plan imposed a "generic limit" under which directors could have received north of $20 million in stock in a particular year.

The *Calma* Court stated that its reading of *Slager* was that, because the plan imposed nothing more than a generic limit, as opposed to a limit in a specified and fairly narrow range, the defendants were not entitled to a ratification defense. Accordingly, the *Calma* Court rejected the defendants' ratification argument and held that the decision of Citrix's compensation committee to award the RSU to all directors was subject to entire fairness scrutiny.

Key Takeaways

In light of *Calma*, corporations that have incentive plans that do not currently provide specific grant amounts (or narrow ranges) for non-executive directors should consider amending their existing plans or adopting new plans. Ideally, non-executive director compensation would be covered in a separate plan, rather than included in an omnibus plan that also addresses grants to executive officers and other employees. The incentive plans, as amended or newly adopted, should provide for grants to directors in specified amounts (or in narrow specified ranges) or with specified value thresholds. In addition to stock options, restricted stock and other equity-based awards, boards should consider including cash consideration amounts (or narrow ranges) in such plans.[26] If approved by a majority of the disinterested stockholders after full disclosure, the directors' decisions in compliance with those plans should withstand challenge—and any claim should be dismissed at an early stage of the proceeding—except in the most extraordinary circumstances.

Boards should, retain a qualified and experienced independent compensation consultant to advise with respect to such decisions.

In addition, because director-compensation decisions made by the board of a corporation that does not have such a plan in place may be subject to review under the entire fairness standard, the board should ensure that the process by which such decisions are made is thoughtful, deliberate and reasonably designed to result in the corporation obtaining a fair exchange of services for compensation. Boards should, among other things, retain a qualified and experienced independent compensation consultant to advise with respect to such decisions. With input from the compensation consultant, boards also should see that they have selected an appropriate peer group for purposes of determining whether their compensation packages are not off-market. Specifically, boards should be wary of including in any such peer group companies with considerably higher market capitalizations, revenue or net income.[27] As with all important decisions, the board should see that the minutes of its proceedings reflect the bases for its decision, including, if applicable, the advice it received from outside experts.

Notes

1. Section 141(h) of the General Corporation Law of the State of Delaware provides that, "[u]nless otherwise restricted by the certificate of incorporation or bylaws, the board of directors shall have the authority to fix the compensation of directors." 8 *Del. C.* § 141(h). In *Cambridge Retirement System v. Bosnjak*, 2014 WL 2930869 (Del. Ch. June 26, 2014), the Delaware Court of Chancery found that the legislative intent of Section 141(h) was to overturn early case law questioning the directors' power to set their own compensation, but not to affect the standard by which the decision would be reviewed.
2. --- A.3d ----, 2015 WL 2265535 (Del. Ch. Apr. 30, 2015).
3. Defendants also moved to dismiss on the grounds that plaintiff had failed to make a pre-suit demand on Citrix's board under Court of Chancery Rule 23.1, but the Court found that plaintiff had adequately demonstrated that demand was futile under the so-called *Rales* test, noting that all three of the directors on the compensation committee that had approved the awards were also beneficiaries. *Id.*
4. 2015 WL 2265535, at *8.
5. 802 A.2d 257 (Del. 2002).
6. 2015 WL 2265535, at *8.
7. *Id.*
8. 2002 WL 31888343 (Del. Ch. Dec. 18, 2002).
9. *Id.* at *10 n.26.
10. 1988 WL 46064 (Del. Ch. May 9, 1988).
11. *Id.* at *7.
12. *Id.*
13. *Id.* at *8.
14. *Calma,* 2015 WL 2265535, at *9.
15. 90 A.2d 652 (Del. 1952).
16. *Id.* at 655-56 ("The interested character of the directors who voted for the stock option plan makes their action voidable only and thus subject to stockholders' ratification. The attack, therefore, of the defendant upon the stock option plan is limited to the question of whether or not it constitutes a gift of corporate assets to executives.") (citations omitted).
17. *Id.* at 656-58.
18. 1995 WL 441999 (Del. Ch. July 19, 1995). In *Steiner*, a stockholder challenged a stock option plan that provided for, among other things, the grant to each non-employee director of an option to purchase 10,000 shares on the anniversary of such director's election to the board. Relying on *Kerbs*, the *Steiner* Court held that, because the plan had been approved by the stockholders after full disclosure, the stockholder plaintiff was required to show that the directors' approval of the plan was *ultra vires*, illegal or fraudulent or that the approval of the plan constituted a gift of corporate assets or waste. *Id.* at *7.
19. 699 A.2d 327 (Del. Ch. 1997). Although the plan at issue in *Vogelstein* was slightly different from the plan at issue in *Steiner* in that the plan provided for, among other things, an annual grant of *up to* 10,000 options per year, the Court held that a stockholder-approved rights plan was subject to review under the waste standard. *Id.* at 336.
20. 1999 WL 1009210, at *1-3, n.9 (Del. Ch. Oct. 25, 1999) (holding that "[d]ecisions of directors who administer a stockholder approved director stock option plan are entitled to the protection of the business judgment rule, and, in the absence of waste, a total failure of consideration, they do not breach their duty of loyalty by acting consistently with the terms of the stockholder approved plan" and noting the various limitations of the board's authority under the plan at issue, explaining "[i]t is implicit that the Board may only exercise discretion within these parameters and is free to award as many options as the Plan permits or as few as zero options").
21. 91 A.2d 786 (Del. Ch. 1952).
22. *Id.* at 790.
23. 914 A.2d 647 (Del. Ch. 2007).
24. *Calma*, 2015 WL 2265535, at *13.
25. 2012 WL 2501105 (Del. Ch. June 29, 2012).
26. *Steiner*, 1995 WL 441999, at *7 (Del. Ch. July 19, 1995) (indicating that the cash component of director compensation would also be subject to the waste standard if paid in accordance with a plan validly adopted by a fully informed and disinterested stockholder vote).
27. *Calma*, 2015 WL 2265535, at *18.