Compensation and Proxy Litigation and the Latest Delaware Cases

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Delaware Compensation Cases Origin and Trends

- Why a role for a state court?
- Historical Underpinnings
  - Options backdating cases
- Two current theories
  - Self dealing and ineffective stockholder approval
  - Failure of Plan Compliance

Director Compensation
Equity Granting Practices

- Director equity awards were typically provided under separate "formula plans" up until the change to Rule 16b-3 in 1996
- Most director equity awards are now included in stockholder approved "omnibus" stock plans that also cover executive officers and key employees
- No securities, tax or exchange listing rule requires a limit on equity grants to a non-employee director
- Currently, it is common for omnibus stock plans to either:
  - Not use a grant limit for director equity grants, or
  - Apply the same grant limit that applies to executive officers for §162(m) purposes

Director Compensation
Seinfeld v. Slager

- Decision issued June 29, 2012 on defendants' motion to dismiss the complaint for failure to state a claim
- Case ultimately settled
- Plaintiff sued Republic Services, Inc. over compensation paid to directors in 2009 and 2010 under a stockholder approved stock incentive plan
- 2009 restricted stock awards valued at $743,000 - 2010 restricted stock awards valued at $320,000
- Plaintiff alleged total director compensation far exceeded the compensation of Republic's peers
- Plaintiff argued awards should be reviewed under the entire fairness standard

Director Compensation
Seinfeld v. Slager

- Defendants countered that awards under the plan were reviewable under the business judgment rule because the stockholders approved the plan and moved to dismiss the complaint
- Defendant's position was based on *In re 3 Com Corp. Shareholders Litigation*, C.A. No. 16721 (Del. Ch. Oct. 25, 1999) (decided by then Vice Chancellor, later Chief Justice, Steele))
- Central to the Court's decision on the motion to dismiss was the Court's calculation of the value of the awards that the directors could make to themselves under the limits of the plan – 875,00/director with a value of $21M and total value for all directors of $260M

Director Compensation
Seinfeld v. Slager

- The Court cited to the very case the defendants relied on (*3 Com*) and noted that an important element of the decision was that the *3 Com* plan had "sufficiently defined terms" that it could give business judgment rule treatment as a result of stockholder approval.
- In contrast, the *Seinfeld* Court found that the plan before it "lack[ed] sufficient definition" to warrant BJR review.
- The Court went to state: "sufficiency of definition that anoints a stockholder-approved option or bonus plan with business judgment rule protection exists on a continuum" and then noted:
  - The more definitive 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.

Director Compensation
Seinfeld v. Slager

- The Court concluded:
  - In reading the Complaint and the [Plan], I find no effective limits on the total amount of pay that can be awarded through time-vesting restricted stock units. The plan before me confers on the Defendant Directors the theoretical ability to award themselves as much as tens of millions of dollars per year, with few limitations; therefore, I find that the Defendant Directors are interested in the decision to award themselves a substantial bonus. While the Defendant Directors may be able to show that the amounts they awarded themselves are entirely fair, their motion to dismiss must be denied with respect to this claim.
- Complaints based on the Seinfeld theory continue to be filed.

Director Compensation
Calma v. Templeton

- Decision issued by DE Chancery Court on April 30, 2015 on defendants' motion to dismiss the complaint for failure to state a claim
- Case remains active
- Plaintiff sued Citrix over compensation paid to directors in 2011 - 2013 under a stockholder approved stock incentive plan
- 2010: 3,333 RSUs valued at $143,852 , 10,000 stock options valued at $101, 116 with total director comp between $288,718 and $312,040
- 2011: 4,000 RSUs valued at $339,320 with no stock options - total director comp between $386,716 and $425,570
- Compensation increased by over $100,000 on average for each non-employee director
- Stock price dropped shortly after 2011 RSUs were granted

Director Compensation
Calma v. Templeton

- Plaintiff alleged that the RSUs, when added to the directors' cash compensation, far exceeded the compensation of Citrix's peers
- Similar to <u>Seinfeld v. Slager</u>, plaintiff argued that should be reviewed under the entire fairness standard – no "meaningful limits" plan limits
- Defendants countered that awards under the plan were reviewable under a corporate waste standard because stockholders had approved the plan
  - Seinfeld v Slager was "incompatible with the deference owed under settled Delaware law to the fully-informed collective decision of disinterested shareholders to grant directors discretion within broad parameters to exercise business judgment"

Director Compensation
Calma v. Templeton

- The Court reviewed sixty years worth of decisions by the DE Supreme Court and Chancery Court
- Sample v. Morgan
  - The Delaware doctrine of ratification does not embrace a "blank check" theory. . . *[T]he mere approval by stockholder of a request by directors for the authority to take action with broad parameters does not insulate all future action by the directors within those parameters from attack."* *(emphasis in original text)*
- Stockholder ratification is generally available as a defense to avoid the entire fairness standard when:
  - the plan sets forth the specific compensation to be received by directors
  - the plan sets forth "director-specific ceilings"
  - the specific awards in question have been approved by stockholders

Director Compensation
Calma v. Templeton

- The Court emphasized that the plan only imposed a general limit that no person could receive more than 1 million RSUs per calendar year – this amount of RSUs was worth $55 million at time of filing
- The Court found that a stockholder ratification defense was not available:
  - "the Citrix stockholders were never asked to approve – and thus did not approve – any *action bearing specifically on the magnitude for compensation for the Company's non-employee directors*. . . the Plan does not set forth any director-specific "ceilings" on the compensation that could be granted to the Company's directors" *(emphasis in original)*
- The Court found no "meaningful differences" between the allegations in Calma and those in Seinfeld, and that these decisions are consistent with longstanding Delaware precedent
- Breach of fiduciary duty and unjust enrichment claims allowed to proceed against defendant directors who received RSUs; corporate waste claim was dismissed

Director Compensation
Implications of Seinfeld and Calma Decisions

- Consider having separate equity award limits for director compensation in order to avoid the entire fairness standard of review
- Consider alternatives for designing director compensation limits
  - Separate sublimits for both director stock options/SARs and full value share awards?
  - Share limit vs. dollar limit?
- Obtain independent advice when developing peer group for director equity compensation, evaluating peer group practices and establishing limits
- When possible, avoid having directors approve their own individual director compensation (e.g., compensation for a special committee)
- Advantages of not using a new stand alone director stock plan
  - one vs. two plans to document and administer
  - shares under executive stock plan unavailable to make grants under director stock plan
  - multiple S-8 filings / prospectuses

Failure to Comply with Plan Terms

- In a July 17, 2014 opinion, Chancellor Bouchard noted that "claims challenging payment of compensation to an officer or director… based on an alleged violation of the terms of a compensation plan" are a "seemingly increasing area of litigation" in the Chancery Court. *Friedman v. Diller*, C.A. No. 9161-CB (Del. Ch. July 17, 2014)
- These cases have two inter-related elements –
  - Have the clear terms of the plan been violated?
  - Is a pre-suit demand excused?
- Generally, these cases are derivative cases, which require as a pre-condition to a plaintiff maintaining the suit either:
  - A recognized basis for excusing the pre-suit demand; or
  - Pre-suit demand is made and the board decides to have the suit maintained by plaintiff

Failure to Comply

- Pre-suit demand is excused if the plaintiff alleges particularized facts that create a “reasonable doubt” either that:
  - The directors are disinterested and independent; or
  - The challenged transaction was otherwise the product of a valid exercise of business judgment.
- Several cases have held that the second prong above will be met if the plaintiff allege facts that show that there was a “clear or intentional” violation of a compensation plan.
- If the plaintiff can establish a “clear or intentional” violation, the case can go forward.
- Importantly, an ambiguity concerning the plan will not be enough to excuse demand.

Failure to Comply

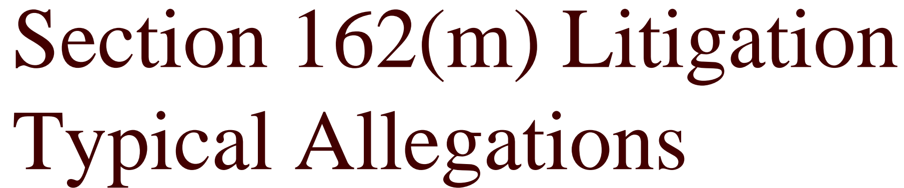
- Examples of cases in which clear plan violations were found include:
  - Issuing 9.5 million shares more than are authorized under the plan. (*Sanders v. Wang,* C.A. No. 16640 (Del. Ch. Nov. 8, 1999))
  - Repricing of stock options after a precipitous price decline required stockholder approval under the plan and could not be implemented unilaterally by the board (*CALPERS v. Coulter*, C.A. No. 19191 (Del. Ch. Dec. 18, 2002))
  - Grant of "spring-loaded" or "bullet-dodged" stock options based upon material non-public information (yet to be announced earnings announcement) violated the plan terms (*Weiss v. Swanson*, 948 A.2 433 (Del. Ch. 2008))
  - Award to single award recipient of stock options that exceeded annual plan limits. (*Pfeiffer v. Leedle*, C.A. No. 7831-VCP (Del. Ch. Nov. 8, 2013))

Failure to Comply

- Several complaints have been filed recently suggesting that the plaintiffs are still active in this area
- Plaintiffs are increasingly willing to bring these complaints on a “stand alone” basis rather than as part of a larger attack on the board
- The cases serve as reminder of the importance of good record keeping and documentation and the observance of corporate formalities (e.g., stock options vs. restricted stock)

Section 162(m) Litigation

- Companies are being targeted for awarding executive compensation in an amount or manner that violates the plans terms and, as a result, allegedly filed false or misleading proxy disclosures
- Over 30 companies have been the subject of this type of litigation (and many others to demands on the board of directors)
- Typical claims include:
  - Breach of fiduciary duty
  - Unjust enrichment
  - Corporate waste
- Most cases filed in either DE Chancery Court or U.S. District Ct., D. DE
- These suits have been around for several years but there has been a recent uptick in this litigation



Section 162(m) Litigation Typical Allegations

- Payments under the awards granted by the compensation committee were substantially certain to occur
  - Performance goals were not pre-established sufficiently in advance
- Performance criteria approved by stockholders were materially changed
- Description of the performance criteria used for performance goals was false or misleading
- Performance goals were too vague
- Failure to comply with plan terms, including stated share limits

Section 162(m) Litigation Typical Allegations

- Company did not limit nonperformance-based compensation to less than $1 million
  - Freedman v. Adams, DE Supr. Ct (1/14/2013) (ruling Board did not commit corporate waste by intentionally deciding to pay non-deductible bonuses not intended to be exempt from §162(m))
- Compensation committee retained too much discretion
- Failure to timely seek stockholder re-approval
- Relief under Rev Rul 2008-13 was outside IRS statutory authority and void

Section 162(m) Litigation
Current Environment

- Expect more §162(m) related claims to be filed
  - Often included as part of cases in which there is an alleged failure to follow plan terms
- Plaintiffs are not waiting for IRS to deny deductions before proceeding with filing complaints
- Plaintiffs' bar is closely scrutinizing proxy disclosures to find potential allegations that will survive a motion to dismiss
- Poorly drafted proxy statements regarding §162(m) can significantly increase the risk of:
  - intrusive discovery if complaint cannot be dismissed at the MTD stage
  - settlements with payment of plaintiffs' attorneys fees

Section 162(m) Litigation Risk Mitigation Strategies

- Do not commit to grant compensation that will be exempt from §162(m) if the plan or share increase is approved
- Disclose that the compensation committee reserves the right:
  - to grant non-performance based compensation
  - to grant shares under existing equity plan if new equity plan is not approved
- Disclose that awards intended to qualify as "performance-based compensation" under §162(m) may not qualify for this exemption
- Review the entire proxy for statements that might be construed as inconsistent with §162(m) compliance
  - CD&A
  - shareholder proposals

Davidson vs. Henkel
Exposure for Faulty Tax Administration

- Decision issued on January 6, 2015 by U.S. District Ct., E.D, MI
- Employer liable under ERISA for failing to correctly administer special timing rule for FICA taxation of nonqualified deferred compensation
- Special timing rule:
  - FICA tax assessed on deferred amount at time of vesting
  - Earnings not subject to FICA tax
- Failure to follow special timing rule results in FICA tax on all deferred compensation plan payments
  - Assuming no ability to file an amended tax return
- Failure to follow special timing rule harms participants – more payments subject to the 6.2% portion of the FICA tax

Davidson vs. Henkel
Exposure for Faulty Tax Administration

- Plaintiff's claim was successful because the Court determined that the FICA administration of the plan did not allow for the recovery of "benefits due to him under the terms of his plan"
- In effect, the Court found that the plan document resulted in an implied promise to administer the plan in a manner that will result in favorable tax consequences for participants
- Decision sets forth a roadmap for claims against an employer for violations of Section 409A and 280G cutback provisions
- Consider adding plan provisions clarifying that:
  - No particular tax result is promised under the plan
  - Participants are solely responsible for all taxes on amounts payable by the employer under the plan