

Cooley

Comp Talks

The Latest re: Director Compensation

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attorney advertisement

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Why Are We (Still) Talking About Director Compensation Litigation?

- Plaintiffs' firms are still focused on compensation/proxy matters
- Shareholder derivative litigation is risky, expensive and distracting
 - Generally no business judgment protection for directors setting their own compensation
 - Prior case law highlighted the benefit of shareholder ratification and importance of a meaningful limit
- *Investors Bancorp* and its progeny have altered the landscape
 - In December 2017, Delaware Supreme Court decided *Investors Bancorp*, which raised questions about effectiveness of those limits and the best way to proceed going forward
 - In May 2019, Chancery Court denied a motion to dismiss in *Stein v. Blankfein*, which reaffirmed standard set in *Investors Bancorp*
- Litigation risk + market trends = appropriate for board discussion

A photograph of a winding asphalt road through a forest. The road has double yellow lines in the center and white lines on the edges. The trees are in autumn, with leaves in shades of orange, yellow, and red. The sun is visible in the distance, creating a bright glow. The text "Legal Background" is overlaid in the center of the image.

Legal Background

Standard of Review

- Unless restricted by the charter or bylaws, Section 141(h) of the Delaware General Corporation Law empowers directors to set their own compensation
- Director self-compensation decisions are inherently self-interested decisions and, therefore, when properly challenged, those decision will generally be reviewed under the exacting “**entire fairness**” standard (instead of the more deferential “**business judgment rule**”)
- **However**, if a fully-informed, uncoerced, and disinterested majority of stockholders approve the board’s compensation decisions, then the business judgment rule applies

Entire Fairness vs Business Judgment

- **Entire Fairness**
 - Highest level of review under Delaware law
 - Applies to self-interested or conflicted decisions (such as directors setting their own compensation)
 - Burden is on defendants to establish that the challenged decision was a product of both fair dealing and fair price
- **Business Judgment**
 - Rebuttable presumption in favor of directors' decisions
 - Will apply to director self-compensation decisions if fully informed majority of stockholders approve the challenged decision

What Is the Stockholder Ratification Defense?

- Historically, in reviewing challenges to director compensation, courts have recognized the stockholder “ratification” defense (and applied the business judgment rule) where stockholders approved:
 1. The specific director awards;
 2. A self-executing plan (i.e., directors had no discretion in making awards); and
 3. A discretionary plan with “meaningful limits” on the amounts directors could award themselves
- As a result, many boards adopted discretionary equity plans with general limits and submitted those plans to stockholders for approval believing they would benefit from the business judgment rule

How Did *Investors Bancorp* and Its Progeny Change Things?

- In December 2017, the legal landscape changed with the Delaware Supreme Court's decision in *Investors Bancorp, Inc. Stockholder Litigation*, 177 A.3d 1208 (Del. 2017)
 - Supreme Court reversed the Chancery Court, which had dismissed plaintiff's complaint because the equity plan contained "meaningful, specific limits on awards to all director beneficiaries"
 - Supreme Court reaffirmed ratification defense (and application of the business judgment rule) for stockholder-approved, non-discretionary awards – i.e., where stockholders have ratified the **specific awards** or a **self-executing plan**
 - Supreme Court effectively rejected stockholder ratification (and application of the business judgment rule) to discretionary awards of director compensation from a stockholder-approved equity plan with "meaningful limits"

How Did *Investors Bancorp* and Its Progeny Change Things? (cont'd)

- As noted by the Supreme Court:
 - “[W]hen stockholders have approved an equity incentive plan that gives directors discretion to grant themselves awards within general parameters, and a stockholder properly alleges that the directors inequitably exercised that discretion, then the ratification defense is unavailable to dismiss the suit, and the directors will be required to prove the fairness of the awards to the corporation.”
- And, because entire fairness review (unlike review under the business judgment rule) typically forecloses early dismissal of a derivative lawsuit, *Investors Bancorp* suggested that it would be easier for stockholders to challenge director compensation awards and threaten companies with expensive litigation

How Did *Investors Bancorp* and Its Progeny Change Things? (cont'd)

- Following *Investors Bancorp*, some commentators were skeptical that the decision would significantly impact future director compensation claims given the extreme facts of that case
- But, in May 2019, Chancery Court denied a motion to dismiss in *Stein v. Blankfein*, a case with far less egregious facts than in *Investors Bancorp*
 - “Regarding excessive compensation, the Complaint is not, to my mind, particularly strong. I find, however, that the Plaintiff has met her low pleading burden regarding director compensation: to point to ‘some facts’ implying lack of entire fairness, which will require a unified review of both process and price.”
- *Stein* reaffirms application of entire fairness review and underscores the low bar for a plaintiff to clear in challenging “excessive” director compensation

What Is Relevant in an Entire Fairness Review?

- Burden is on directors to demonstrate fair price and fair process. Considerations include:
 - Absolute size of subject awards
 - Size of awards relative to company's historical practices and peer companies
 - Timing, extent, and content of board (or applicable committee) deliberation on director compensation. For example:
 - Whether the board (or applicable committee) was advised by experts (e.g., an external compensation consultant)
 - Purpose and justification for the awards
 - Whether awards were made pursuant to a stockholder-approved plan, and whether that plan contains director compensation limits and/or guidelines
 - Adequacy of disclosure about director compensation, including the process used to set compensation levels

Shareholder Derivative Lawsuits

- Director compensation typically challenged with derivative lawsuit
 - Shareholder sues directors *on behalf of the company*
 - Shareholder can file and control litigation if:
 - Pre-litigation demand served on board and refused, OR
 - Demand would be futile
- Demand is futile if there is reasonable doubt that: (1) a majority of the board is disinterested and independent; OR (2) the challenged decision was not a valid exercise of business judgment
- Director self-compensation decisions are inherently self-interested and, thus, demand is typically futile in these circumstances and litigation can proceed

Shareholder Demand Letters

- As a precursor to derivative litigation, stockholders (through counsel) often send “demand” letters: typically (1) a “notice of shareholder concerns” or (2) a books & records demand

1. Notice of Shareholder Concerns

- Letter from a stockholder to the board of directors accusing the board of awarding excessive compensation to non-employee directors
 - Invites the board to take “immediate remedial measures” (e.g., reducing retainers and fees, limiting total director compensation, adopting mandatory ownership guidelines)
- Letter expressly disclaims that it is a pre-suit demand (to avoid waiving demand futility argument in derivative case)

Shareholder Demand Letters

1. Notice of Shareholder Concerns (cont'd)

- Most commonly sent by Jeff Norton of Newman Ferrara (in the director compensation context)
- Immediate next step is for the board (or a committee) to evaluate the underlying facts and allegations
- Essentially three paths forward:
 - Refuse to adopt reforms and litigate subsequent derivative case
 - Make some reforms and privately settle; opposing counsel will demand a mootness fee (for conferring a benefit on the stockholders)
 - Make some reforms and seek court approval of settlement

Shareholder Demand Letters

2. 220 Demands

- Letter from a stockholder to the company demanding production of certain books and records (under section 220 of the Delaware General Corporation Law)
- Most commonly sent by Purcell Julie & Lefkowitz LLP (in the director compensation context)
- Company has 5 business days to respond; typical initial response is to:
 - Challenge the stated purpose – stockholder must have a proper purpose and state credible facts to support that purpose
 - Challenge the scope – demand must be narrowly tailored to proper purpose

Shareholder Demand Letters

2. 220 Demands (cont'd)

- Essentially three paths forward
 - Refuse to produce any (or enough) documents in response to the demand and potentially litigate a 220 action in Delaware Chancery Court
 - Negotiate a production of documents (subject to a confidentiality agreement with an incorporation provision) to resolve the 220 demand
 - E.g., Board minutes and materials related to director compensation
 - Negotiate some director compensation reforms to resolve 220 demand and any anticipated excessive compensation claim

Recent Settlements



Clovis Oncology (*Solak v. Barrett*)

- Complaint filed in Delaware Chancery Court in May 2017 (before *Investors Bancorp*) by Jeff Norton of Newman Ferrara LLP
 - Outside directors' average compensation (e.g., \$617,735 in 2015) was allegedly excessive
- Parties settled in February 2018; board agreed to cap director compensation and submit plan to a binding stockholder vote
 - Compensation set at \$350,000 to \$425,000 for incumbent directors and \$525,000 to \$637,500 for new appointees (*excluding* committee fees)
- Court approved the settlement in May 2018; plaintiff's counsel awarded \$395,000 in fees
- In June 2018, stockholders rejected director compensation plan
 - Company submitted a revised plan (with lower equity amount) to stockholders, which was approved in June 2019

Goldman Sachs (*Stein v. Blankfein*)

- Complaint filed in Delaware Chancery Court in May 2017 (before *Investors Bancorp*) by Brian Farnan of Farnan LLP
 - Direct Claims – alleged failure to make required disclosures in connection with equity plan and proxy statements
 - Derivative Claims – outside directors’ average compensation (e.g., \$605,000 in 2016) was allegedly excessive
- Parties settled in March 2018; board agreed to a number of disclosure-related reforms
- Court rejected the settlement in October 2018 because the release of derivative claims was not fair
- Court denied defendants’ motion to dismiss in May 2019
 - Case is now in discovery

Ophthotech (*Cano v. Guyer*)

- Complaint filed in New York state court in February 2018 by Jeff Norton of Newman Ferrara LLP
 - Outside directors' average compensation (e.g., \$850,651 in 2016) was allegedly excessive
- Parties settled in November 2018; board agreed to cap outside director compensation and submit plan to a binding stockholder vote
 - Total compensation (cash and equity) capped at \$275,000 for incumbent directors and no more than 2X the existing incumbent limit for new appointees
- Court approved settlement in March 2019; plaintiff's counsel awarded \$300,000 in fees
- Stockholders approved the amended director compensation plan at the 2019 annual meeting

OvaScience, Inc. (*Fulton v. Dipp*)

- Complaint filed in Delaware federal court in June 2018 by Jeff Norton of Newman Ferrara LLP
 - Outside directors' average compensation (e.g., \$362,434 in 2015) was allegedly excessive
- Board agreed to cap outside director compensation and submit plan to a binding stockholder vote
 - Compensation capped at \$300,000 for incumbent directors and \$600,000 for new appointees (*including* fees for committee service)
- Court approved the settlement in August 2018; plaintiff's counsel awarded \$300,000 in fees
- Stockholders approved the amended director compensation plan at the 2018 annual meeting

Abeona Therapeutics (*Mahon v. Ahn*)

- Complaint filed in Delaware federal court in November 2018 by Steve Purcell of Purcell Julie & Lefkowitz LLP
 - Outside directors' average compensation (e.g., \$581,333 in 2017) was allegedly excessive
 - Plaintiff engaged in pre-suit investigation, including serving a 220 demand for books and records
- Board agreed to set outside director compensation at a specified amount and submit plan to a binding stockholder vote
 - Director Compensation Plan to stay in place for 3 years and Compensation Committee with review compensation annually with help of a consultant
- Court approved the settlement in May 2019; plaintiff's counsel awarded \$240,000 in fees

UltraGenyx (*Solak v. Welch*)

- Complaint filed in Delaware Chancery Court in November 2018 by Jeff Norton of Newman Ferrara LLP
 - Outside directors' average compensation (e.g., \$407,725 in 2017) was allegedly excessive
- Parties fully briefed a motion to dismiss
- Court heard oral argument in August 2019, but has not yet issued a decision

Other Cases to Watch

- **SalesForce.com** – *Pill v. Benioff*, C.A. No. 2018-0922 (Del. Ch.)
 - Three complaints filed between December and January 2019
 - Excessive non-employee director compensation (\$550K-\$600K in 2016-18)
- **China Automotive** – *Heng Ren Silk Road Invs. v. Chen*, C.A. No. 2019-0010 (Del. Ch.)
 - Complaint filed January 7, 2019 by Kessler Topaz
 - Excessive non-employee director compensation (\$138K in 2017)
- **RR Donnelley** – *Dahle v. Pope*, C.A. No. 2019-0136 (Del. Ch.)
 - Complaint filed February 20, 2019 by Jeff Norton
 - Excessive non-employee director compensation (\$300K in 2017)
- **Ambac** – *Palmer v. Green*, C.A. No. 2019-0307 (Del. Ch.)
 - Complaint filed April 25, 2019 by Steve Purcell
 - Excessive non-employee director compensation (\$350K-\$450K in 2016-18)

Who Is Likely to Be Targeted?



Considerations

- Director pay relative to peers
- Aspirational peer group
- Company performance
- Industry
- Disclosures
- BUT: all plaintiffs' firms really need is a stockholder plaintiff

Myths

- My company is too small to be on plaintiffs' firms radars (e.g., market cap ~\$26M OvaScience, ~\$61M Sanchez Energy, ~\$75M Ophthotech)
- We haven't increased director compensation lately and so we aren't at risk (e.g., OvaScience director comp exceeded \$300K in 2015, but dropped sharply in 2016 to \$100-\$140K and was below \$100K for most directors in 2017)
- Our director compensation is relatively modest and so we aren't at risk (e.g., Ultragenyx average 2017 director comp of \$400K and current market cap of \$2.75B)
- We haven't been sued yet and so we're probably safe

Best Practices



Making Director Compensation Decisions (Amount and Type)

- Determine appropriate market range
- Determine appropriate market (typically same peer group used for executive compensation)
- Consider that when range from lowest to highest paid boards is narrow, outliers are easier to identify
- Cash versus stock
- Types of equity awards
- Watch out for fixed share grants
- What about special service?

Making Director Compensation Decisions (Process)

- Compensation consultant advice
- Frequency of market review (annual? every other year?)
- Rigorous process around determination of peer companies
- Determined by Compensation Committee or Nominating & Governance Committee?
- Establish limits?
- Stockholder engagement?
- Special considerations in connection with an M&A transaction

Disclosing Director Compensation

- Director compensation disclosure historically a compliance exercise and intentionally minimalist
- Reg S-K Item 402(k) requires a narrative description of any material factors necessary to an understanding of the director compensation in the director compensation table, but does not require the “how” or the “why” that is required in CD&A for executive compensation
- Consider enhanced proxy disclosure describing thoughtful process and any market-based analysis used to determine director compensation

Formula Plan?

- Pro: ensures protection of business judgment rule
- Con: limits flexibility of board to adjust director comp
- Is including a meaningful limit in a stockholder-approved plan a good compromise?

What Are the Practical Issues with Limits?

- What is a “meaningful” limit and yet leaves appropriate future flexibility?
- What does the limit cover?
- How is the limit expressed?
- Should we specify exceptions to the limit?
- How often will we seek re-approval of the limit?
- Should we specify current annual director compensation in shareholder-approved plan document?

Sample Limits

Non-Employee Director Compensation Limit. The aggregate value of all cash and equity-based compensation granted or paid, as applicable, by the Company to any individual for service as a Non-Employee Director with respect to any fiscal year of the Company will not exceed (i) a total of \$200,000 with respect to any such cash compensation and (ii) \$800,000 in total value with respect to any such equity-based compensation (including Awards and any other equity-based awards), calculating the value of any such awards based on the grant date fair value of such awards for financial reporting purposes.

Non-Employee Director Compensation Limit. The aggregate value of all compensation granted or paid, as applicable, to any individual for service as a Non-Employee Director with respect to any period commencing on the date of the Company's Annual Meeting of Stockholders for a particular year and ending on the day immediately prior to the date of the Company's Annual Meeting of Stockholders for the next subsequent year, including Awards granted and cash fees paid by the Company to such Non-Employee Director, will not exceed (i) \$750,000 in total value or (ii) in the event such Non-Employee Director is first appointed or elected to the Board during such period, \$900,000 in total value, in each case calculating the value of any Awards based on the grant date fair value of such Awards for financial reporting purposes.

Additional Data Point: ISS Policy

- Institutional Shareholder Services (ISS) announced a policy in 2018 to recommend against the re-election of board members responsible for approving or setting outside director pay when there is a pattern (two or more consecutive years) of excessive pay without a compelling rationale or other mitigating factors
- Excessive director compensation is defined as the top 2-3% in the company two-digit GICS sector and combines small and mid-cap companies
- **First possible adverse recommendations under the policy will be in 2020**

Director Compensation Proposals

- Some companies sought approval of non-employee director compensation policies or programs in 2019
- ISS more deeply analyzed director compensation when a proposal was on the table, including analyzing items such as:
 - Relative magnitude of director comp compared to companies of a similar profile
 - Director stock ownership guidelines and holding requirements
 - Equity award vesting schedules
 - Mix of cash and equity-based compensation
 - Presence of meaningful limits on director compensation
 - Quality of disclosure surrounding director compensation

A green rectangular sign with rounded corners and a white border, tilted at an angle. The word "Disclosure" is written in a bold, white, sans-serif font across the sign. The sign is supported by two silver poles. The background is a bright blue sky with a few wispy white clouds and a sun flare in the upper right corner.

Disclosure

TD Ameritrade's 2019 Proxy Statement

As part of its annual review of director compensation, the Corporate Governance Committee requested that **Semler Brossy conduct an independent review of the Company's non-employee director compensation program.** Semler Brossy conducted an in-depth assessment of each element of compensation and of the compensation program structure in comparison to the companies in the fiscal year 2018 peer group used for executive compensation purposes. Semler Brossy's review found that the **cash compensation paid** to our non-employee directors **was consistent generally** with the median paid in our peer group, **but the amount of our equity retainer was below the fiscal year 2018 peer group median.** The amount of equity retainer had not been increased since 2010. Following the recommendation of the Corporate Governance Committee, on November 16, 2018, the board of directors approved a \$15,000 increase in the annual equity retainer for our non-employee directors (other than the chairman), from \$130,000 to \$145,000. This increase resulted in bringing the annual equity retainer to approximately the peer group median. There were no other changes to the terms of the compensation for non-employee directors, including no changes to vesting, proration and deferral.

Visa's 2019 Proxy Statement

The Compensation Committee, which is comprised solely of independent directors, has the primary responsibility for reviewing and considering any revisions to our director compensation program. The Compensation Committee undertook its annual review of the type and form of compensation paid to our non-employee directors in connection with their service on the Board and its committees for fiscal year 2018. The Compensation Committee considered the results of **an independent analysis completed by FW Cook**. As part of this analysis, FW Cook **reviewed non-employee director compensation trends and data from companies** comprising the same executive compensation peer group used by the Compensation Committee in connection with its review of executive compensation. Pursuant to this compensation review process, and after considering FW Cook's advice that our non-employee director compensation program is **consistent with that of our peer group**, the Compensation Committee **made no changes** to the amounts of non-employee director compensation for fiscal year 2018. As noted in last year's proxy statement, however, starting in fiscal year 2018, the annual equity award vests immediately upon grant.

From Millendo Therapeutics' 2019 Proxy Statement

Our Board has adopted a director compensation policy for non-employee directors, effective as of December 7, 2018. The policy provides for the compensation of non-employee directors with cash and equity compensation. Under the policy, each non-employee director will receive an annual board service retainer of \$40,000. The non-executive chairperson will receive an additional service retainer of \$30,000. The chairperson of each of our audit committee, our compensation committee and our nominating and corporate governance committee will receive additional annual committee chair service retainers of \$15,000, \$10,000 and \$8,000, respectively. Other members of our audit committee, our compensation committee and our nominating and corporate governance committee will receive additional annual cash retainers of \$7,500, \$5,000 and \$4,000, respectively, for each such committee of which they are a member. The annual cash compensation amounts set forth above are payable in equal quarterly installments, payable in arrears following the end of each calendar quarter in which the board service occurs, prorated for any partial months of service. We will also reimburse all reasonable out-of-pocket travel expenses incurred by non-employee directors in attending meetings of our Board or any committee thereof.

VOTE

A close-up photograph of four light-colored wooden blocks standing upright on a dark, textured wooden surface. Each block has a single black letter printed on its front face, which together read 'VOTE'. The blocks are arranged in a slightly staggered line. In the background, several other wooden blocks are scattered and out of focus, with some showing letters like 'Y', 'O', and 'N'. The lighting is warm and directional, creating soft shadows and highlighting the texture of the wood.

Copart, Inc.'s 2019 Proxy Statement

On October 12, 2018, our board of directors approved, upon the recommendation of our compensation committee, a cash and equity director compensation program for our executive chairman and non-employee directors for the fiscal year ending July 31, 2019 through and including the fiscal year ending July 31, 2022. Our executive chairman and founder, Willis J. Johnson, will participate in the program but will be entitled to receive certain additional perquisites approved by the compensation committee, in its sole discretion, that the non-employee directors are not eligible to receive. These additional perquisites for Mr. Johnson are not part of this compensation program for which stockholder ratification is being sought. **Although our board of directors is not required to seek or receive stockholder approval**, it is submitting this proposal to stockholders for approval and ratification **in the interest of good corporate governance**. Our **board of directors has agreed to abide by the stockholder vote**. If stockholders do not approve this proposal, the proposed changes in director compensation for our executive chairman and non-employee directors will not go into effect, and the board of directors will re-evaluate its director compensation practices.

Boston Properties, Inc.'s 2019 Proxy Statement

Although we are not legally required to seek or receive stockholder approval for the Director Compensation Plan, **we are submitting the plan to stockholders for approval.** Our Compensation Committee and Board of Directors last reviewed our non-employee director compensation in 2016, or three years ago.

The Director Compensation Plan implements recommendations that our Compensation Committee made to the full Board based on a comprehensive review of the structure and amounts of our existing compensation for non-employee directors. For the 2019 review, our Compensation Committee engaged FW Cook to help ensure that our non-employee director compensation remains competitive and is generally consistent with “best” practices. Our Compensation Committee also sought recommendations from FPL regarding compensation for the role of non-executive chairman.

The Director Compensation Plan does not reserve any additional shares of common stock for issuance; all equity grants made under the Director Compensation Plan must be made pursuant to the 2012 Plan or another separately approved equity plan.

STAAR Surgical Company's 2018 Proxy Statement

The Board of Directors believes that stockholder approval, on an **advisory, non-binding basis, of the annual compensation program for our non-employee directors**, as revised by the Board of Directors in March 2019 (the “Annual Compensation Program”), is in the best interests of us and our stockholders because it allows us to attract and retain qualified non-employee directors who are important to our long-term success. We believe that the compensation paid to non-employee directors pursuant to the Annual Compensation Program is reasonable and appropriate, in line with market practice, data and recommendations received from Radford (our independent compensation consultant), appropriately compensates our non-employee directors for services as non-employee directors and aligns the interests of our directors and our stockholders.

Although the Board of Directors is not required to seek or receive stockholder approval of our Annual Compensation Program, the Board of Directors is doing so on an advisory basis in the interest of good corporate governance.



Advice for 2020

- Everyone
 - Educate and discuss at board level
 - Ensure there is a ***rigorous process*** for setting director compensation:
 - Pay special attention to director compensation disclosure in 2020 proxy statement
 - Consider enhanced proxy disclosure describing the thoughtful process and any market-based analysis used to determine compensation
- Companies anticipating 2020 equity plan proposals
 - Consider including formula grants or specific limit on director compensation – discuss pros and cons
 - Start discussing form of limit (should cover stock and cash and be expressed as dollar value) and what's appropriate

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