



# Comp Talks

## The Latest re: Director Compensation Litigation

Pete Adams, Cooley

Mark Borges, Compensia

Jessica Valenzuela Santamaria, Cooley

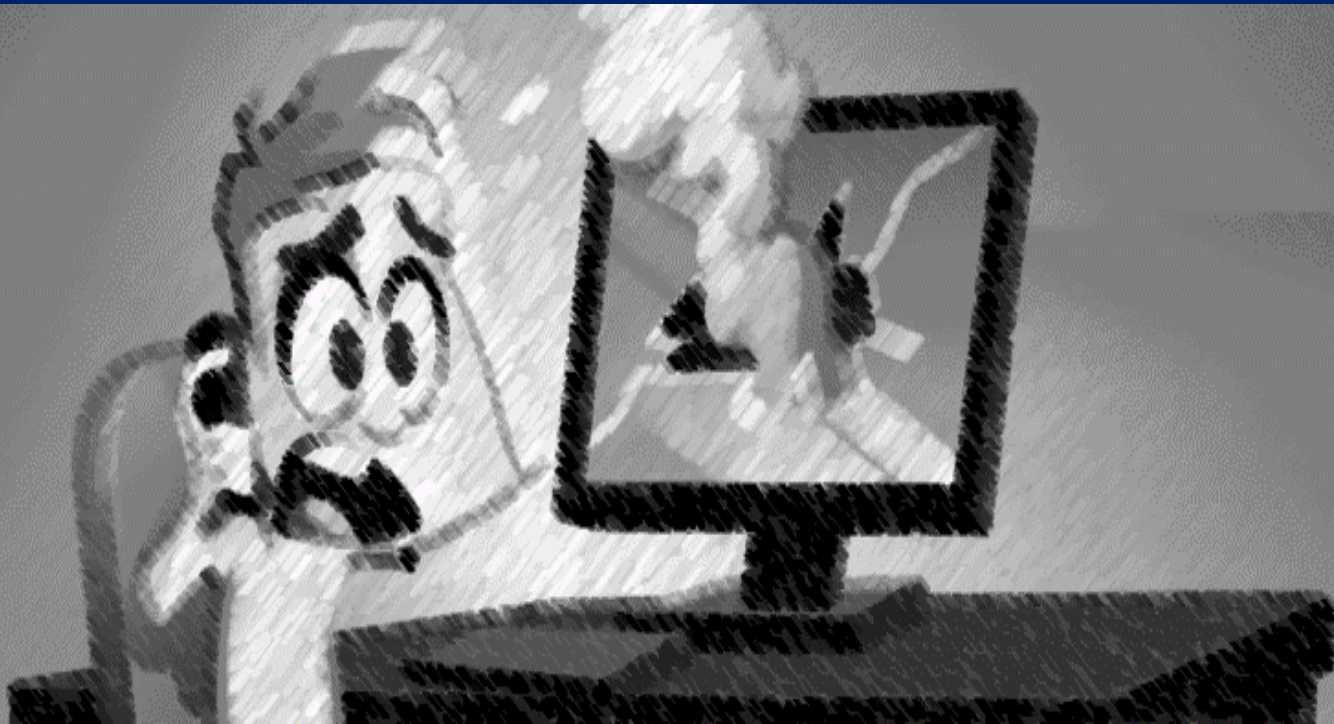
*Moderated by Amy Wood, Cooley*

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# Why Are We 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
- December 2017 *Investors Bancorp* decision by the Delaware Supreme Court raised questions about the effectiveness of those limits and the best way to proceed going forward
- Litigation risk + market trends = appropriate for board discussion



A scenic photograph of a two-lane asphalt road winding through a forest. The road has a double yellow line in the center and white lines on the edges. The trees on both sides are in peak autumn foliage, with shades of orange, red, and yellow. The sun is visible through the trees in the distance, creating a warm, golden light. 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* 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* Change Things?

- 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* has made it easier for stockholders to challenge director compensation awards and threaten companies with expensive litigation

# What Is Relevant in an Entire Fairness Review?

- Whether awards were made pursuant to a stockholder-approved plan
- Absolute size of subject awards
- Size of awards relative to company's historical practices
- Size of awards relative to peer company practices
- Timing and stated purpose of awards
- Whether the stockholder-approved plan contains appropriate limits and/or guidelines for determining awards which serve as a restriction on director discretion
- Whether the board (or applicable committee) was advised by an external compensation consultant
- Adequacy of disclosure about director compensation (both when stockholder approval of the applicable plan is sought and thereafter in proxy statement), including the process used to set compensation levels

# Shareholder Derivative Lawsuits

- Director compensation likely to be 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 two 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

# Recent Settlements





# Clovis Oncology (*Solak v. Barrett*)

- Complaint filed 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)
- Delaware Chancery Court approved the settlement in May 2018; plaintiff's counsel awarded \$395,000 in fees
- In June 2018, stockholders rejected the director compensation plan
  - Path forward unclear (this contingency not discussed in settlement agreement)



# Goldman Sachs (*Stein v. Blankfein*)

- Complaint filed 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, including (among others):
  - Plaintiff’s counsel to review draft proxy disclosures
  - GS to disclose that its director compensation is “highest among its U.S. peers”
  - GS to disclose expected impact of Tax Cuts & Jobs Act on compensation
- Delaware Chancery Court rejected the settlement in October 2018 because the release of derivative claims is not fair



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

- Complaint filed 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)
- Delaware federal 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

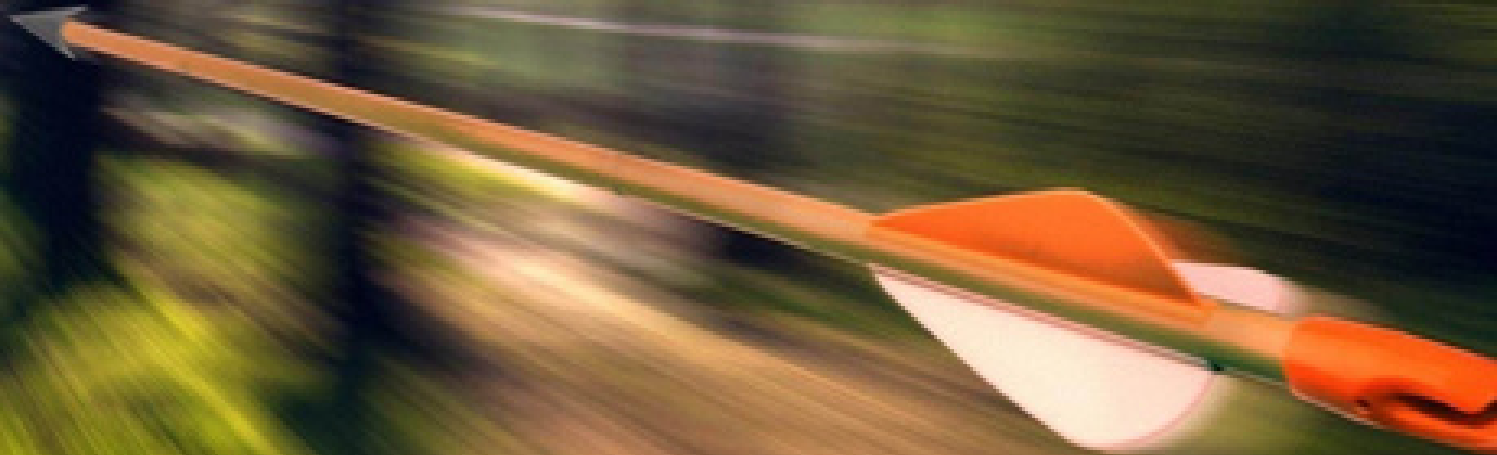
# Ophthotech (*Cano v. Guyer*)

- Complaint filed in June 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
- Stockholders to vote on the amended plan at the 2019 annual meeting
- *TBD*: Court approval of settlement and award of attorney's fees

# Other Cases to Watch

- **Sanchez Energy** – *Armato v. Sanchez*, C.A. No. 2018-0642-SG (Del. Ch.)
  - Complaint filed August 29, 2018 by Jeff Norton
  - Outside directors' average compensation (e.g., \$354,872 in 2017) was allegedly excessive
- **Abeona Therapeutics** – *Dos Ramos v. Rouhandeh*, C.A. No. 2018-0680-JRS (Del. Ch.)
  - Complaint filed September 17, 2018 by Jeff Norton
  - Outside directors' average compensation (e.g., \$581,333 in 2017) was allegedly excessive
- **Ultragenyx** – *Solak v. Welch*, C.A. No. 2018-0810-KJM (Del. Ch.)
  - Complaint filed November 7, 2018 by Jeff Norton
  - Outside directors' average compensation (e.g., \$407,725 in 2017) was allegedly excessive

# 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?

# 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 reapproval 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) has announced a policy 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
- **However**, ISS recently announced that it is still revising its methodology for identifying outliers
- Therefore, ISS will not be issuing adverse director recommendations under the policy in 2019. Rather, the **first possible adverse recommendations under the policy will be delayed until 2020**
- ISS expected to increase transparency in its December 2018 FAQs

# Sample ISS Write-Up re “High Director Compensation” in 2018

## “HIGH DIRECTOR COMPENSATION

Non-employee director [\_\_\_\_\_] received total compensation in the last fiscal year of \$2,164,664. This amount is a significant outlier as compared to non-employee directors in the same industry and index. This represents a cost to shareholders and raises questions about the impact on director independence.

According to the 2018 proxy, approximately \$2.02 million of [\_\_\_\_\_]’s total compensation includes fiscal 2017 consulting fees of \$1,608,250; benefits valued at \$158,278 paid under the terms of the Retirement Benefits Package Agreement; income tax gross-up payments of \$97,518; and administrative support inclusive of benefits valued at \$155,615. The amount also includes the cost of home and office security systems and services that were covered by the company.

Given that [\_\_\_\_\_]’s consulting fees and benefits in aggregate amount to sizable compensation, shareholders should continue to monitor this issue.”

# Director Compensation Proposals

- Some companies sought approval of non-employee director compensation policies or programs in 2018
  - Some proposals were advisory
  - Mixed results – Glass Lewis reported 44 proposals (GL supported 79.5%; 1 failed and 3 received greater than 25% opposition); ISS reported 16 proposals (ISS supported 56%; 2 failed and 2 received greater than 25% opposition)
- 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

# Example: JP Morgan Chase's 2018 Proposal

- Equity plan proposal to extend term of plan, increase share reserve and incorporate following terms of director compensation program:
  - Annual base retainer per director of \$350,000 per year, with discretion to increase by up to \$25,000 but not until January 2020
  - Additional retainers for special service for lead independent director and chairs of committees, with discretion to increase by up to \$5,000 but also not until January 2020
  - Board discretion to pay any director an additional retainer or other fee, including for service on any specific service committee or for any other special service, in its discretion
- Approved at 2018 annual meeting with over 95% support



**Disclosure**



# From T. Rowe Price Group's 2018 Proxy Statement

“The Nominating and Corporate Governance Committee periodically reviews non-employee director compensation and benefits and recommends changes, if appropriate, to the full Board based upon its review and consideration of competitive market practices. Following the engagement in October 2016 of Pearl Meyer & Partners (Pearl Meyer), **an independent compensation consultant, which provided a review of our compensation practices in relation to market conditions**, the Committee determined that its compensation practices were **generally competitive** and that no significant changes were required. However, based on Pearl Meyer’s feedback, we did decide to **provide a fixed dollar amount of equity compensation** of \$200,000 per director once a year rather than a fixed number of shares twice a year, which had been the practice in prior years, in order to better maintain consistent alignment in the relative contribution of cash and equity compensation to total director compensation. We also concluded that, consistent with our approach to equity incentives for our executive officers, we would move away from a menu-based plan that allowed directors to select among options, restricted shares, and restricted stock units to a consistent awarding of full value share awards to our directors. Directors maintained the right to select between restricted shares or restricted stock units in order to provide an opportunity for deferral of income if a director so elects.”

# From Goodyear's 2018 Proxy Statement

“The Compensation Committee reviews pay levels for non-employee directors **each year** with **assistance from F.W. Cook**, who prepares a comprehensive assessment of Goodyear’s non-employee director compensation program. That **assessment includes benchmarking of director compensation against the same peer group used for executive compensation purposes, an update on recent trends in director compensation, and a review of related corporate governance best practices.**

Following that review, the Board of Directors, consistent with the recommendation of the Compensation Committee, increased outside directors’ annual cash compensation from \$125,000 to \$130,000 and the grant date fair value of annual stock awards from \$140,000 to \$145,000, effective July 1, 2017. The Lead Director received an additional \$55,000. The chairpersons of the Audit and Compensation Committees received an additional \$20,000, and the chairpersons of all other committees received an additional \$15,000. Any director who attended more than 24 Board and committee meetings received \$1,700 for each additional meeting attended (\$1,000 if the meeting was attended by telephone). In addition, the Board may form special committees from time to time and determine the compensation of the chairperson of such committees. Travel and lodging expenses incurred in attending Board and committee meetings are paid by Goodyear.”

# From OvaScience's 2018 Proxy Statement

“Specifically, in establishing the aggregate limits on compensation payable, the mix of cash and equity-based compensation, and the Holding Period requirement with respect to shares purchased upon exercise of options granted under the Director Compensation Policy, the Compensation Committee **worked with its independent compensation consultant, Pearl Meyer and Partners LLC, to identify compensation trends in non-employee director compensation and amounts payable to non-employee directors by peer companies...**The compensation payable for calendar year 2018 under the proposed Director Compensation Policy is **in line with the median of peer non-employee director compensation programs presented by Pearl Meyer**, and the new Holding Period required for the option shares is a leading practice among those presented programs. Our Board believes the proposed approach to compensation appropriately aligns the interests of our non-employee directors and our stockholders in the future success of the Company, while assuring we do not provide excessive compensation.”

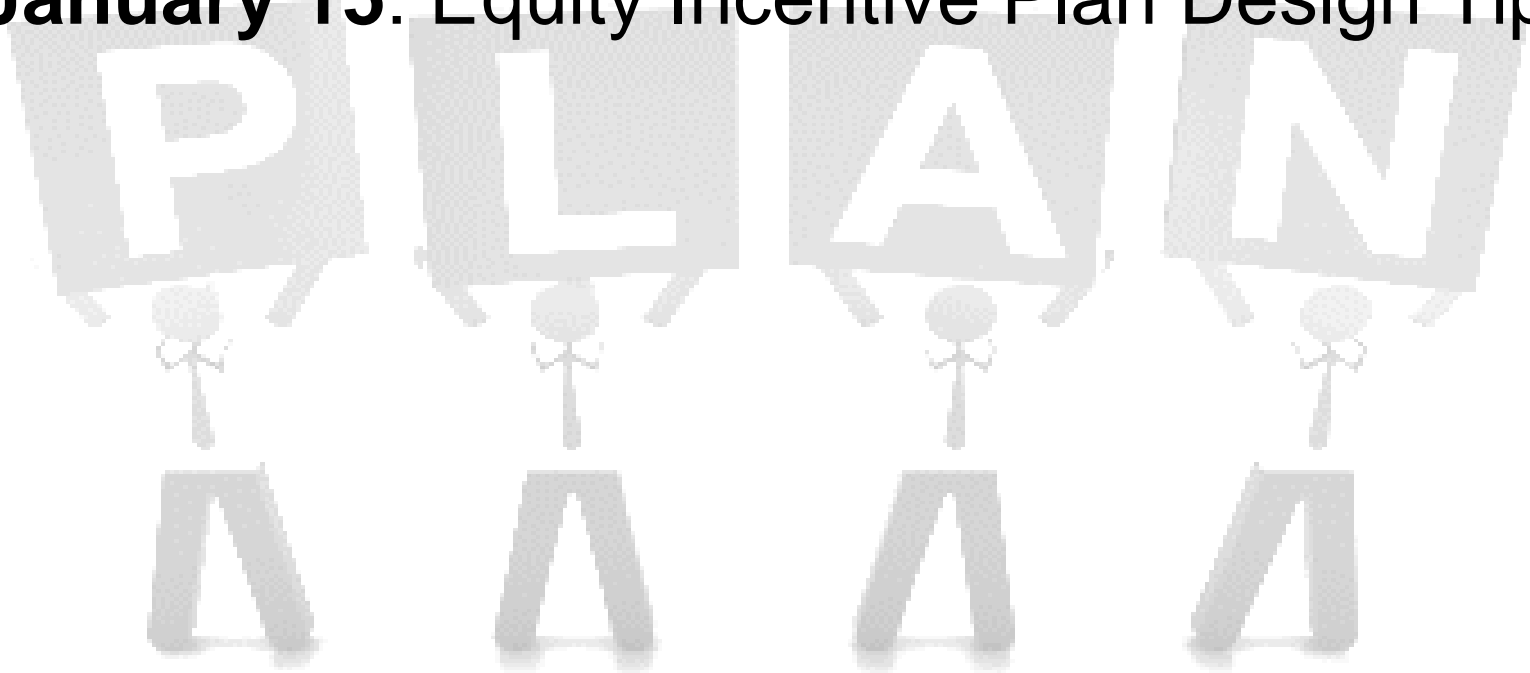


# Advice for 2019

- 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 2019 proxy statement
  - Consider enhanced proxy disclosure describing the thoughtful process and any market-based analysis used to determine compensation
- Companies anticipating 2019 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

# Future Comp Talk Programs

- **December 18:** Proxy Advisory Firm Policy Updates
- **January 15:** Equity Incentive Plan Design Tips



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