Protecting Your Director Compensation Decisions from Claims of "Excessive Pay"

A recent case in the Delaware Court of Chancery serves as a sharp reminder that decisions involving director compensation may not be protected by the "business judgment" rule because directors are inherently conflicted when setting their own pay. As a result, board compensation committees should review their processes and disclosure around director compensation to minimize the risk of claims of excessive pay.

The Citrix Systems Lawsuit

In April 2014, a stockholder of Citrix Systems, Inc. brought a lawsuit against the company's non-employee directors alleging that their receipt of RSU awards constituted a breach of their fiduciary duties. The majority of the directors' compensation consisted of these RSU awards, which the board compensation committee granted pursuant to the company's stockholder-approved equity compensation plan. While the plan imposed an annual limit of one million shares that could be granted to an eligible participant in any calendar year, it did not impose any limits on director equity awards. The plaintiff contended that the RSU awards were, when combined with the cash compensation that the non-employee directors received, "excessive" compared to the compensation received by directors at certain of Citrix's peers.

In denying the company's motion to dismiss, the Delaware Court of Chancery held that the compensation committee's action involved a conflicted transaction that was not protected by the "business judgment" rule because the members of the committee also received the awards (see *Calma v. Templeton* et al). Instead, the Court required the company to demonstrate that these self-determined compensation arrangements were entirely fair to the company – a standard that it was unable to meet.

The company made two principal arguments in support of its motion to dismiss:

- The equity compensation plan under which the awards were granted had been previously approved by the company's stockholders, thereby ratifying the awards.
- The awards were fair because they were consistent with the practices of its compensation peer group.

The Court rejected both arguments, noting that the company had failed to show that it had sought or obtained stockholder approval of any action bearing specifically on the magnitude of the compensation paid to its non-employee directors – rather than just the plan generally. Further, the Court held that, applying the "entire fairness" standard, the plaintiff raised a meaningful question as to whether some of the companies in the compensation peer group were not appropriate comparators because they were much larger, based on revenue, market capitalization, and net income, than Citrix. Since it found these to be reasonable factual issues, the Court refused to dismiss the lawsuit on procedural grounds.

Earlier Lawsuits Raise Similar Claims

The Citrix decision follows in the steps of other lawsuits in recent years alleging that directors breached their fiduciary duty when setting their own pay. In 2012, shareholders of Republic Services brought an action against the board of directors claiming that the directors had breached their fiduciary duty in granting themselves equity awards (see *Seinfeld v. Slager*). Following the denial of the company's motion to dismiss, the suit ultimately settled in 2014 with the board agreeing to adopt limits on the number of shares that could be awarded to individual directors in any calendar year.

The *Seinfeld* decision has spurred a handful of similar suits. For example, just last year, a lawsuit was filed against the board of directors of Facebook concerning its director pay actions. A decision in this matter is expected later this year.

With the Delaware courts showing a willingness to allow these "excessive pay" lawsuits to survive a motion to dismiss, the stakes have clearly increased. Companies are now less likely to prevail at an early stage of the litigation, raising the costs and time commitment necessary to defend the suit and, in all probability, increasing settlement costs.

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Protecting Your Director Compensation Decisions from Claims of "Excessive Pay" (continued)

Avoiding Litigation

In view of these developments, we recommend that boards of directors review their director compensation program and, where appropriate, take steps to minimize their litigation exposure. This may include:

- Ensuring that your equity compensation plan contains a realistic and meaningful limit on the size of director equity awards; and
- Obtaining shareholder approval of such limits.

Further, it's worth noting the importance of the compensation peer group that is used for referencing the competitive market when setting director pay. While no peer group is wholly unassailable, developing and using a reasonable set of peers when evaluating market practices may help when defending the reasonableness of your director pay levels.

We also recommend that companies ensure that the compensation disclosure in their annual report on Form 10-K and proxy statement cover their director pay program thoughtfully and clearly. This includes both describing your actual pay practices, and explaining the rationale for your director compensation decisions.

Need Assistance?

Compensia has extensive experience in helping companies design and implement compensation programs for the members of the board of directors. If you would like assistance in developing or reviewing your director pay practices, or if you have any questions on the subjects addressed in this Thoughtful Pay Alert, please feel free to contact your Compensia consultant. ■

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