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Memorandum

Delaware Chancery Court Rules that Self-Interested Director Compensation Decisions May, Under Certain Circumstances, Be Subject to Entire Fairness Review

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A recent Delaware Chancery Court decision confirms that, as the court held three years ago in *Seinfeld* v. *Slager*, there is no shareholder ratification defense for self-awarded director compensation granted under a stockholder-approved option or bonus plan that lacks "sufficiently defined terms" or "some *meaningful* limit" on director discretion.[1]

I. General Standard

Director decisions are generally afforded wide latitude under the business judgment rule.[2] The protections of the business judgment rule, however, "can only be claimed by disinterested directors."[3] The "directors can neither appear on both sides of a transaction nor expect to derive any personal financial benefit from it in the sense of self-dealing . . . ."[4]

A decision by directors to award themselves compensation necessarily fails this test, subjecting the decision to the entire fairness standard –a higher level of scrutiny. However, the court will apply the more deferential

[1] *See Calma* v. *Templeton*, 2015 Del. Ch. LEXIS 126, at *35 (Del. Ch. Apr. 30, 2015) (quoting *In re 3COM Corp. Shareholders Litig.*, 1999 Del. Ch. LEXIS 215, *11 (Del. Ch. Oct. 25, 1999)); *Seinfeld* v. *Slager*, 2012 Del. Ch. LEXIS 139, at *40 (Del. Ch. June 29, 2012) (stating that plans must impose some "meaningful limit" on director compensation).

[2] When reviewing a business decision under the business judgment rule standard, the court presumes that in making the business decision, "the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interest of the company." *Aronson* v. *Lewis*, 473 A.2d 805, 812 (Del. 1984).

[3] *Id.*

[4] *Id.*

business judgment rule to a director compensation decision if such decision was "made under a stock option plan approved by the corporation's shareholders."[5] This is known as a stockholder ratification defense.

II. *Calma* and *Slager*: A Recent Trend

In a recent pair of shareholder derivative cases, the Delaware Court of Chancery narrowed the application of the stockholder ratification defense. Most recently, on April 30, 2015, the Court of Chancery held in *Calma* v. *Templeton* that a board decision to grant restricted stock units ("RSUs") to the non-employee directors of Citrix Systems, Inc. was subject to the entire fairness standard of review.

In *Calma*, the board's compensation committee granted RSU awards under Citrix's 2005 Equity Incentive Plan (the "Plan").[6] The Plan was approved by a majority of Citrix's stockholders in a prior vote.[7] While the majority of the directors' compensation consisted of these RSU awards, the Plan applied to multiple classes of beneficiaries – not just directors – including Citrix's officers, employees, consultants and advisors.[8] The only limit on compensation imposed by the Plan was that "no beneficiary could receive more than one million shares (or RSUs) per calendar year."[9] There were no sub-limits in the Plan based on the beneficiary's position within Citrix (*e.g.*, separate limits for non-employee directors and consultants).[10] Based on Citrix's stock price, one million RSUs were worth over $55 million on the date the lawsuit was filed.[11]

Although Citrix's non-employee directors were awarded between 3,000 and 4,000 RSUs in each of 2011, 2012, and 2013 – well below the one million RSU limit under the Plan – the stockholder plaintiff challenged the RSU grants for these years, arguing that they were "excessive" when compared to the compensation received by directors of Citrix's peers. The defendants took the position that the Board's decision to award directors RSUs should be subject to the business judgment rule standard of review because the decision was consistent with the Plan and stockholders had ratified the Plan. Relying on a prior case, *Seinfeld* v. *Slager*, the plaintiff argued that even though the RSU awards were granted under the stockholder-approved Plan, the defendants must "establish the entire fairness of the RSU Awards because the Plan 'has no meaningful limits' on the total equity compensation that the Company's non-employee directors could hypothetically receive."[12]

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[5] *In re 3COM Corp. Shareholders Litig.*, 1999 Del. Ch. LEXIS 215, at *11.
[6] *Calma*, 2015 Del. Ch. LEXIS 126, at *2.
[7] *Id.*
[8] *Id.* at *5.
[9] *Id.* at *2.
[10] *Id.* at *5.
[11] *Id.* at *2.
[12] *Id.* at *25.

The court agreed with the plaintiff, holding that "advance stockholder approval of a compensation plan with multiple classes of beneficiaries and a single generic limit on the amount of compensation that may be awarded in a given year" is not sufficient to establish a ratification defense.[13] Accordingly, the court ruled that the board's decision was subject to the entire fairness standard of review under which the directors have the burden of establishing that "'the transaction was the product of both fair dealing and fair price.'"[14] In distinguishing the case before it from the sixty years of precedent the defendants pointed to, the court noted that in prior cases the ratification defense was recognized because stockholders approved specific director compensation awards or Plans with director-specific compensation ceilings.[15] By contrast, in *Calma*, the stockholders "were never asked to approve—and thus did not approve—any *action bearing specifically on the magnitude of compensation for the Company's non-employee directors*."[16] The Citrix stockholders did not vote in favor of the specific RSU grants at issue or vote to impose a meaningful limit on directors specifically.

Calma continues a trend begun three years earlier in a similar case: *Seinfeld* v. *Slager*.[17] In *Slager*, a Republic Services, Inc. stockholder challenged the fairness of RSUs granted to the company's non-employee directors under the company's stockholder-approved compensation plan.[18] As in *Calma*, the beneficiaries of the plan included the company's directors, officers, and employees. The plan similarly did not include specific RSU grants for directors or set forth a director-specific ceiling on compensation. Rather, the plan imposed generic limits of 10.5 million shares total and 1.25 million shares that any one beneficiary could receive per year.[19] With twelve directors, the Board could have theoretically awarded each director 875,000 RSUs, which were worth over $21.6 million per recipient at the time.[20] The court held that even though the

[13] *Id.* at *26.
[14] *Id.* at *22-23 (quoting *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993)).
[15] *Id.* at *47-48. For cases in which the ratification defense was applied, *see, e.g., Cambridge Retirement System* v. *Bosnjak*, 2014 WL 2930869 (Del. Ch. June 26, 2014) (stockholders specifically approved the awards at issue); *In re 3COM Corp. Shareholders Litig.*, 1999 Del. Ch. LEXIS 215 (the plan imposed a director-specific ceiling); *Lewis* v. *Vogelstein*, 699 A.2d 327 (Del. Ch. 1997) (stockholders approved a plan that detailed the specific compensation to be paid to directors); *Steiner* v. *Meyerson*, 1995 WL 441999 (Del. Ch. July 19, 1995) (same); *Kerbs* v. *California Eastern Airways, Inc.*, 90 A.2d 652 (Del. 1952) (same).
[16] *Calma*, 2015 Del. Ch. LEXIS 126, at *51 (emphasis in the original). It should be noted that the defendants argued that because the proxy statements "disclosed the specific compensation that was granted to non-employee members of the Board during the prior years (i.e., the RSU Awards issued in 2011 and 2012), the vote to 'ratify, confirm, and approve' the Plan was the functional equivalent of a vote in favor of the RSU Awards." *Id.* at *53. The court disagreed.
[17] *Seinfeld* v. *Slager*, 2012 Del. Ch. LEXIS 139 (Del. Ch. June 29, 2012).
[18] *See id.*; *see also Calma*, 2015 Del. Ch. LEXIS 126, at *41-*44.
[19] *Slager*, 2012 Del. Ch. LEXIS 139, at *39.
[20] *Id.*

stockholders approved the plan, the director compensation decision was still a self-dealing transaction because the stock plan lacked "sufficient definition."[21] Accordingly, the court held that the board's decision was subject to the entire fairness standard of review.

III. Pending Cases

At least two similar cases challenging director compensation decisions are currently pending before the Delaware Chancery Court: one involving Facebook, Inc. and one involving Celgene Corporation. In a shareholder derivative complaint filed against Facebook on June 6, 2014, the plaintiffs allege that Facebook's directors awarded themselves unfair, excessive compensation and are therefore liable for breach of fiduciary duty, waste of corporate assets, and unjust enrichment.[22] As in *Calma* and *Slager*, Facebook's shareholders approved an Equity Incentive Plan. However, the only limits in the plan are a total limit of 25 million shares and a per person annual limit of 2.5 million shares. At the time the complaint was filed, 2.5 million Facebook shares were worth approximately $145 million, which the complaint alleges is "not a true limit."[23]

The shareholder derivative lawsuit on behalf of Celgene Corporation, filed in October 2014, alleges that the compensation made to non-employee directors in 2013 and 2014 was excessive compared to grants made to directors of peer companies.[24] As in *Calma*, *Slager*, and the case against Facebook, Celgene has a

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[21] *Id.* at *41. The court opined:

> "The sufficiency of definition that anoints a stockholder-approved option or bonus plan with business judgment rule protection exists on a continuum. Though the stockholders approved this plan, there must be some meaningful limit imposed by the stockholders on the Board for the plan to . . . receive the blessing of the business judgment rule . . . . A stockholder-approved carte blanche to the directors is insufficient. The more definite 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."

Id. Although this principle as it applies to director compensation was announced in *Slager*, the idea that a stockholder-approved carte blanche is insufficient to qualify for the protection of the business judgment rule is not new. As Chancellor Bouchard noted in *Calma*, this idea was actually announced years earlier in *Sample* v. *Morgan*, 914 A.2d 647, 663-664 (Del. Ch. 2007). In *Sample*, the court explained that "the Delaware doctrine of ratification does not embrace a 'blank check' theory. . . . [T]he mere approval by stockholders of a request by directors for the authority to take action within broad parameters does not insulate all future action by the directors within those parameters from attack."

[22] *See* Verified Shareholder Derivative Complaint for Breach of Fiduciary Duty, Waste of Corporate Assets, and Unjust Enrichment at 1-2, *Espinoza* v. *Zukerberg*, C.A. No. 9745-CB (Del. Ch. June 6, 2014).

[23] *See id.* Facebook filed a Motion to Dismiss and for Summary Judgment. The court is expected to hear oral arguments on the motion on July 28, 2015.

[24] *See* Verified Stockholder Derivative Complaint for Breach of Fiduciary Duty, Waste of Corporate Assets, and Unjust Enrichment, *Steinberg* v. *Casey*, C.A. No. 10190-CB (Del. Ch. Oct. 2, 2014).

shareholder-approved Stock Incentive Plan. The only limit under Celgene's 2013 plan is that no individual can receive more than 1.5 million shares per year.[25] As of the date of filing, 1.5 million shares were worth approximately $130 million.[26]

IV. Implications of the Recent Director Compensation Cases

Calma and *Slager* seem to reflect an emerging trend of shareholders challenging director compensation decisions made pursuant to shareholder-approved plans that do not set a meaningful limit on compensation paid to outside directors. As the Delaware Court of Chancery has held, these decisions are subject to the entire fairness standard of review rather than the business judgment rule, according the board's decision less deference. Given shareholders' recent successes, companies may want to include in shareholder-approved plans meaningful limits on the aggregate compensation levels – cash and non-cash – permitted to be paid to outside directors.

[25] *Id.* at 9.
[26] *Id.*

If you have any questions or would like additional information, please do not hesitate to contact **Yafit Cohn** at (212) 455-3815 or yafit.cohn@stblaw.com, or any other member of the Firm's Public Company Advisory Practice, or any of the following members of the Firm's Executive Compensation and Employee Benefits Practice or Litigation Practice:

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