

Director Compensation After *Calma v. Templeton*: Proactive Steps to Consider

Delaware case exposes director compensation to heightened “entire fairness” standard absent adequate stockholder ratification

The Delaware Court of Chancery recently decided a case that makes it easier for plaintiffs to sue companies for their director compensation. The decision, in *Calma v. Templeton*,¹ denied a motion to dismiss a breach of fiduciary duty claim based on Citrix Systems, Inc.’s past director equity awards. The Court of Chancery held that the business judgment rule does not apply to such awards, which must instead be reviewed under the “entire fairness” standard, even if stockholders previously approved the plan under which the directors received their equity awards.

Background: *Calma* case

Eight non-employee directors of Citrix received restricted stock units under the Citrix 2005 Equity Incentive Plan in 2011 through 2013.² The Plan limited equity awards to a maximum of one million shares (or RSUs) for each participant (including the non-employee directors) in any calendar year. However, like many U.S. public company equity plans, the Plan contained no specific limit on awards to non-employee directors and no specific formula denominating director awards. The Citrix stockholders had previously approved the Plan.

A plaintiff sued, alleging that the RSU awards, when combined with cash compensation, were excessive when compared to those of Citrix’s peers. The suit brought claims for breach of fiduciary duty, waste of corporate assets and unjust enrichment against Citrix and the members of its Board of Directors. The defendants moved to dismiss all claims arguing that the director compensation was ratified by the stockholder approval of the Plan and did not constitute waste of Company assets. The Court of Chancery refused to dismiss the claims for breach of fiduciary duty and unjust enrichment, although the Court held that the director compensation did not constitute waste and dismissed that claim. The court held that, although the stockholders had approved the Plan, the Plan lacked adequate specificity regarding director equity awards and therefore did not ratify the director awards.

Stockholder ratification under *Calma*

A decision of a board of directors generally receives the protection of the business judgment rule and will be subject to challenge only if a plaintiff can show that the decision had no rational business purpose. If, however, a stockholder rebuts the business judgment standard by, for example, establishing that a board decision was not approved by a majority of disinterested directors, then the court will review such decision under the higher standard of “entire fairness” (*i.e.*, determine whether the decision was made based on fair dealing and at a fair price) unless the decision was “ratified” by the company’s stockholders. Consistent with past cases, *Calma* emphasizes that stockholder approval of an equity incentive plan will not in and of itself be sufficient to constitute such ratification. In *Calma*, the compensation committee

approved the director equity awards (including awards to members of the compensation committee), which made them “interested” in the awards, and, as a result, the court held that the plaintiff had rebutted the presumption of protection under the business judgment rule. Thus, the standard of review turned on whether or not the director awards were ratified. The court held that (a) ratification only occurs “where a majority of informed, uncoerced, and disinterested stockholders vote in favor of a *specific* decision of the board of directors and (b) no ratification by the Citrix stockholders occurred because they “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.*” The court noted that the existence of a general annual limit on awards that was not targeted at non-employee directors and that was far greater than any conceivable reasonable annual pay amount for directors did not provide sufficient specificity.³ As a result, the plaintiff’s claim survived Citrix’s motion to dismiss and remains subject to review under the “entire fairness” standard.

Looking forward: Potential proactive steps to address *Calma*

The court’s refusal to grant Citrix’s motion to dismiss and approval of the “entire fairness” standard was generally not a departure from Delaware precedent. However, the absence of any highly unusual facts in *Calma* highlights the vulnerability that many U.S. public companies face with respect to potential claims alleging breaches of fiduciary duty in connection with director compensation. As a result, companies should take time to carefully review their existing director compensation practices in light of *Calma*. While each company’s situation will be unique, the following provides examples of proactive steps that companies may wish to consider taking in order to reduce the risk of these types of derivative claims.

Review existing director compensation arrangements

First, and prior to implementing any changes to a company’s practices, companies should consider a full scale review and analysis of their director compensation. This review should assess the company’s director compensation to determine what, if any, limits apply and have been approved by the company’s stockholders. It should also compare the company’s director compensation (both cash and equity) against the company’s compensation peer group and review the members of the peer group to make sure that they are reasonably comparable for purposes of evaluating and setting director pay within the company’s marketplace.⁴ This sort of review will help to evaluate the fairness of the director compensation as a whole and, even if following such a review a company believes that its director compensation is and has been fair, what if any changes to director compensation may be appropriate in light of the current litigation environment. In addition, companies will want to weigh the potential litigation defense and deterrent benefits of director limits against the benefits of maintaining flexibility in its compensation arrangements. It will often be advisable to work with the company’s compensation consultant to complete this review.

Amend existing equity compensation plan to institute a specific director compensation limit and seek stockholder approval

Based on the company’s review of its director compensation practices, it may be advisable to add specific limits to director compensation under the company’s stockholder-approved compensation plans, most typically its equity compensation plans. Such plans usually can be amended to include director limits without obtaining stockholder approval.⁵ However, in light of the weight the *Calma* court placed on stockholder ratification of director compensation awards, adding limits without stockholder approval will provide little, if any, benefit. Therefore, we expect that companies that add such specific director limits will generally seek stockholder ratification of these limits.

It is standard market practice in the U.S. for public companies to grant equity-based awards to directors under a broad-based “omnibus” equity compensation plan. In the past, companies typically have sought

stockholder approval of these plans only when necessary to increase the share pool, as required under stock exchange listing rules, or to reapprove performance goals under Section 162(m) of the Internal Revenue Code. However, in light of *Calma* and earlier related cases⁶, a company may determine that it is advisable to amend its equity plans to add specific director compensation limits and seek stockholder approval of these amendments even if it would not otherwise be seeking stockholder approval of any equity plan or amendment next year. Companies will want to weigh carefully the costs and benefits of submitting plans for stockholder approval and may also want to consider seeking such approval in conjunction with other amendments, such as an increase in the share pool.⁷ Inclusion of such a limit could, if approved by stockholders, provide added protection from litigation related to director compensation. While each company needs to consider its specific situation, below are two common forms of limit:

- Annual award limit

In *Calma* and other precedent cases (including *Seinfeld v. Slager*⁸), the Delaware courts refused to treat stockholder approval of an equity plan as ratification of director equity awards because the challenged equity plans did not include meaningful non-employee director award limits.⁹ In particular, in *Citrix* and *Slager*, the court observed that the generic limit on annual equity grants permitted awards to a director with value of up to approximately \$55 million and \$22 million, respectively. In response to such cases, inclusion of an annual limit specifically on director compensation may be appropriate in the company's equity plan. We recommend that the structure and amount of such limit be carefully reviewed with the company's compensation consultants and legal counsel to assure it is a meaningful limitation on director awards. Specific consideration should be given to the scope of such limit (e.g., whether it takes into account both cash and equity compensation¹⁰) and the method of calculating compensation for purposes of such limit (e.g., a specific number of shares or specified dollar amount). A limit that sets an annual cap on the grant date fair value of director equity awards (denominated in dollars) may make sense for many companies. Companies may also consider integrating director cash compensation into the annual cap (perhaps by expressly subjecting all director compensation to the plan limits or by reducing the equity award cap by the amount of cash fees paid to a director during the year). When evaluating a cap, companies will want to consider whether to set separate limits for chairmanships, new directors, special committee service or other special circumstances. Although separate limits may be philosophically appropriate based on the contribution of different individual directors, they will add complexity and may not be necessary for many companies.

- Formula-based grants

While an annual limit as described above may reduce litigation risk, the Delaware courts have not clearly delineated what constitutes a "meaningful" limit on director compensation. Therefore, if a company desires increased certainty regarding the protection of the business judgment rule, it may consider implementing specific formulas for director grants under its equity plan (in lieu of an annual limit) and seek stockholder approval of these formulas. In *Steiner v. Meyerson*¹¹ and *Cambridge Retirement Services v. Bosnjak*¹², two cases that preceded *Calma*, the court held that formula-based director equity awards set forth in a plan approved and ratified by stockholders are protected by the business judgment rule. Of course, this approach will limit flexibility going forward so a company may wish to consider whether to provide for exceptions to the formula-based grants.¹³

Adopt a standalone director compensation plan and seek stockholder approval

Since current standard market practice is to grant director awards under an omnibus equity plan, we expect that many companies that elect to adopt a director limit will do so by amending their existing

omnibus equity plan to include such a limit. However, another alternative some companies may consider is the adoption of a standalone director compensation plan. Prior to the amendment of Rule 16b-3 in 1996, separate director equity plans were commonplace and cases such as *Calma* may provide renewed support for them. By adopting a standalone plan, a company (a) could maintain a distinct framework for its director compensation (and specifically delineate any applicable limits on director compensation), (b) provide for more efficient and defined administration of director compensation (including one-off director awards), (c) fully encompass both cash and equity compensation for directors in one plan, and (d) allow for clear and distinct proxy disclosure and an easier process for stockholder approval of director compensation.¹⁴

Seek stockholder approval of past director compensation

While stockholder approval of director compensation limits and/or a standalone director compensation plan may support approval of future director compensation, companies may also wish to consider as a separate proposal whether to seek stockholder ratification of *past* director compensation under their existing arrangements.¹⁵ If stockholders adequately approve past director compensation, it would provide an additional defense and deterrent against potential lawsuits because decisions related to such compensation should be subject to evaluation under the business judgment rule.¹⁶ It may make the most sense to seek this sort of ratification of past director compensation at the same time the company seeks stockholder approval of a future director compensation amendment or plan. But this could be risky and, as described more generally in the following paragraph, the company should carefully consider its stockholder base and the likelihood of stockholder approval before seeking such ratification. Failing to obtain stockholder approval of past director compensation would highlight director compensation concerns and likely encourage derivative suits.

Consider effects on stockholder approval and director pay disclosure

Finally, any company that intends to seek stockholder approval of director compensation limits or any past compensation should consider how its stockholder base is likely to view such limits and compensation and how Institutional Shareholder Services (ISS) and other proxy advisory firms will view any plan amendment. While a stockholder proposal to approve an amendment to a broad-based equity compensation plan generally falls within the purview of ISS's "equity plan scorecard" analysis, ISS has indicated that amendments without request for additional shares or another modification deemed to increase potential cost may receive a positive recommendation regardless of the results of the "equity plan scorecard" analysis.¹⁷ Nonetheless, a company should consider the potential results of an ISS analysis before submitting any equity plan proposal to its stockholders. If ISS is a concern, proposal of a standalone director compensation limit outside of the company's equity plan (and thus, under current ISS guidelines, not subject to ISS equity plan review) may be appropriate. Also, in light of the increased focus on director compensation that cases such as *Calma* may engender, it will be more important than ever to include clear disclosure of the company's director compensation, including the company's reasoning in establishing the programs and amounts, in its proxy statement and other filings.

Start the process now

Regardless of the ultimate action taken, we recommend that U.S. public companies proactively review their director compensation practices and related compensation plans in light of *Calma*. By reviewing both the level of director compensation and the method of determination and/or limitations on director compensation, companies will be able to better assess their potential exposure to stockholder derivative suits regarding director compensation. There is no single correct response to *Calma* and related cases that will work for every company. However, by proactively reviewing current director compensation

practices a company will be best positioned to determine what, if any, modifications to its director compensation practices and governing documents may be appropriate.

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Endnotes

- ¹ *Calma v. Templeton*, C.A. No. 9579-CB (Del. Ch. April 30, 2015).
- ² The RSU awards were in addition to cash fees ranging from approximately \$29,000 to \$105,000. The cash fees were not part of the plaintiff's claims and issues related thereto are not addressed in this commentary. However, based on decisions in other recent Delaware cases, companies should consider cash compensation when considering any action regarding director compensation (and shareholder approval thereof).
- ³ Most U.S. public company equity plans contain specific limits on awards that may be granted under the plan to any individual participant over a specified period time in order to help ensure that "performance based compensation" payable by the company (including compensation payable pursuant to stock options and other performance based equity awards) will be exempt from the federal income tax deduction limits under Section 162(m) of the Internal Revenue Code. Section 162(m) only applies with respect to compensation paid to certain senior executive officers – not non-employee directors – and, as a general rule, Section 162(m) limits significantly exceed the amount of equity compensation that a typical non-employee director would receive during the specified period.
- ⁴ The court in *Calma* indicated that the "entire fairness" test would consider a company's peer group and that the plaintiff had raised "meaningful questions" with respect to the peer group selected by Citrix.
- ⁵ To the extent any recently post-IPO company remains eligible for transition relief under Section 162(m) of the Internal Revenue Code, any amendment to its equity plan should be carefully structured so that it does not constitute a "material modification" to the plan. While an amendment to implement a director limit will likely not constitute a "material modification," characterization as such by the IRS could jeopardize the company's tax position. Each company should specifically consider this issue in connection with its own circumstances.
- ⁶ See, e.g., *Cambridge Retirement System v. Bosnjak*, 2014 WL 2930869 (Del. Ch. June 26, 2014); *Seinfeld v. Slager*, 2012 WL 2501105 (Del. Ch. June 29, 2012); *Sample v. Morgan*, 914 A.2d 647 (Del. Ch. 2007); *In re 3COM Corp. S'holders Litig.*, 1999 WL 1009210 (Del. Ch. Oct. 25, 1999); *Lewis v. Vogelstein*, 699 A.2d 327 (Del. Ch. 1997); *Steiner v. Meyerson*, 1995 WL 441999 (Del. Ch. July 19, 1995).
- ⁷ To the extent director compensation is in line or below average for the applicable peer group, companies may determine that immediate action is inappropriate and delay stockholder approval of director limits to the next meeting in which approval is sought for other reasons. Such decision must be made on a company-by-company basis.
- ⁸ 2012 WL 2501105 (Del. Ch. June 29, 2012).
- ⁹ See also *Sample*, 914 A.2d 647.
- ¹⁰ Failure to ratify cash compensation could cause such compensation to remain exposed to derivative suits under the "entire fairness" standard. See, e.g., *Bosnjak*, 2014 WL 2930869, at *7; *Steiner*, 1995 WL 441999, at *7.
- ¹¹ 1995 WL 441999 (Del. Ch. July 19, 1995).
- ¹² 2014 WL 2930869 (Del. Ch. June 26, 2014).
- ¹³ Authority to make exceptions to formula-based grant practices should be closely scrutinized and companies may wish to limit the authority to make exceptions to governing bodies or committees that do not otherwise authorize or receive compensation under the formula-based grants. Further, in general, companies should consider the appropriate governing body (*i.e.*, the board, compensation committee, or nominating and corporate governance committee) to be tasked with recommending and/or approving director compensation.
- ¹⁴ Equity plans solely for non-employee directors will generally not be subject to the "equity plan scorecard" analysis utilized by Institutional Shareholder Services, or ISS, for "omnibus" equity plans. See ISS's 2015 U.S. Summary Proxy Voting Guides (available at http://www.issgovernance.com/file/policy/1_2015-us-summary-voting-guidelines-updated.pdf) for more information regarding the plan features necessary to receive a positive ISS recommendation.
- ¹⁵ If a company were to seek stockholder ratification of more than one year of past director compensation, the company would need to consider whether each year of past compensation would need to be presented to stockholders as a separate proposal on the company's proxy card (often referred to as "unbundled") under the interpretation of Securities Exchange Act Rule 14a-4(a)(3) by the Staff of the Securities and Exchange Commission (see Division of Corporation Finance, Compliance & Disclosure Interpretations of Exchange Act Rule 14a-4(a)(3), available at <http://www.sec.gov/divisions/corpfin/guidance/14a-interps.htm>). While we are not aware of any Staff guidance that specifically addresses unbundling in this context, we believe that the Staff would likely assess each situation based on its own facts and circumstances. We believe that, depending on the specific facts and circumstances—such as where the compensation in each year for which stockholder ratification is sought is materially consistent—a company could reasonably seek ratification of two or three years of director compensation in a single proposal.
- ¹⁶ For a description of stockholder ratification principles for past acts, see *Gantler v. Stephens*, 965 A.2d 695 (Del. Supr., Jan. 27, 2009); and *In re KKR Fin. Holdings LLC S'holder Litig.*, 101 A.3d 980 (Del. Ch. 2014).
- ¹⁷ See 2015 U.S. Equity Plan Scorecard Frequently Asked Questions (available at <http://www.issgovernance.com/file/policy/2015-faq-us-equity-plan-scorecard-030315.pdf>).