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TOPIC: Recent Trends in Litigation over Director Compensation Highlight Risks and Suggest Actions to Mitigate those Risks

MARKET TREND: There appears to be increased litigation challenging director compensation levels at public companies, emboldened by recent Delaware case law. Companies may want to consider actions to address the risk of this type of litigation.

SYNOPSIS: Decisions about levels of director compensation often do not receive the protection of the business judgment rule because directors are usually interested in decisions about their own compensation levels. Under Delaware case law, however, stockholders face significant legal barriers in challenging these director compensation decisions if the stockholders previously approved the director compensation levels. These barriers are often referred to as the "stockholder ratification" defense. Last December, in Investors Bancorp, the Delaware Supreme Court narrowed the stockholder ratification defense. The narrowing of this defense appears to have further encouraged stockholder challenges of director compensation levels. As illustrated in three recent settlements, companies have agreed to set stricter limits on non-employee director compensation, institute enhanced governance practices, and pay significant settlement fees.

TAKEAWAYS: An ounce of prevention is worth a pound of cure. Companies should take a fresh look at their decision-making processes regarding non-employee director compensation levels. While there is still some uncertainty about the scope of the stockholder ratification defense after Investors Bancorp, companies may also want to consider asking stockholders to approve those compensation levels.

Challenging Director Compensation: The Stockholder Ratification Defense and *Investors Bancorp*. Directors typically face heightened scrutiny in stockholder litigation challenging decisions about their own compensation levels. Normally, the business judgment rule will not apply to these decisions, because directors, it is presumed, are inherently interested in decisions about their own pay. If stockholders challenge the self-interested director compensation decisions as being excessive, Delaware courts will independently review the decisions as to whether the compensation decisions were "entirely fair" to the stockholders. Because an "entire fairness" review is fact-intensive, any such claims will likely survive a motion to dismiss by the company.

Under the "stockholder ratification" defense, a company can avoid an entire fairness review if stockholders have approved the compensation decision. If the stockholder ratification defense applies, the Delaware courts will apply the business judgment rule and override the compensation decision only if the stockholders can show corporate waste. Given the practical difficulties in establishing corporate waste, if the stockholder ratification defense applies, the company can likely defeat the claims on a motion to dismiss.

For the last several years, a series of Delaware lower court decisions have applied the stockholder ratification defense where the challenged director compensation awards were made under a stockholder-approved equity plan with varying degrees of compensation limits. These cases established a general rule that, if stockholders approved a "meaningful limit" to director compensation awards, director compensation decisions made within the established parameters would have the protection of the stockholder ratification defense.

In it's December 2017 decision in *In re Investors Bancorp, Inc. Stockholder Litigation*[1], the Delaware Supreme Court narrowed the scope of the stockholder ratification defense and possibly eliminated the "meaningful limit" standard. The Court rejected the application of the stockholder ratification defense to stockholder claims of excessive director compensation where stockholders approved only "general parameters" for such awards. The case involved extreme facts—a plan in which the stockholders approved a large aggregate limit on director equity awards (equal to 30% of the total equity compensation share pool), followed by an immediate grant of equity awards to directors, which were disproportionately large compared to prior compensation awards and peer company practices. Although the scope of the stockholder ratification defense after *Investors Bancorp* remains unclear, it appears to have (for now) encouraged companies that face these types of claims to settle disputes rather than risk the costs of litigation.

[1] *In re Investors Bancorp, Inc. Stockholder Litigation, No. 169, 2017, 177 A.3d 1208, 2017 WL 6374741 (Del. 2017), https://courts.delaware.gov/Opinions/Download.aspx?id=266580.*

Three Recent Settlements. In three recent cases, companies have reached settlements where they agreed to modify their director compensation levels and governance practices, perhaps spurred on by the *Investors Bancorp* decision.

Case 1: Clovis. A lawsuit filed against and derivatively on behalf of biomedical firm Clovis Oncology Inc. ("Clovis") reached a proposed settlement in February 2018, which was accepted and finalized by the court in May 2018. In the case styled *Solak v. Barrett* (case no. 2017-0362), filed in May 2017 in the Delaware Court of Chancery, the plaintiff alleged that the annual compensation paid to non-employee directors was excessive and a waste of corporate assets, constituting a breach of the directors' fiduciary duties. According to the complaint, the non-employee director compensation was an average of about $617,000 at the end of 2015, more than two times the average compensation for non-employee directors at Fortune 50 companies. Clovis's stock is traded in the Russell 2000 Index.

The parties were engaged in discovery and discussions about a potential settlement for months before the *Investors Bancorp* decision in December 2017, and the decision appears to have further spurred on those settlement discussions. In March 2018, the parties agreed to a settlement in which Clovis would:

- Present a binding proposal to approve a new director compensation plan at the next stockholder meeting, establishing specific limits on overall compensation payable to non-employee directors (between $350,000 and $425,000 for incumbent directors and between $525,000 and $637,500 for newly appointed directors, exclusive of additional fees for chair and committee service), to remain in effect for 2–5 years[2];

- Retain mandatory stock-ownership guidelines for five years;

- Annually review director compensation, in which it would "be guided by" compensation practices of peer group companies and current best practices; and

- Make certain related disclosures in its annual proxy statement.

Ultimately, the court ordered fees and expenses in the amount of $395,000 to be awarded to plaintiff's counsel.

Case 2: Goldman Sachs. A lawsuit filed against and derivatively on behalf of The Goldman Sachs Group, Inc. ("Goldman Sachs") reached a proposed settlement in March 2018. In the case styled *Stein v. Blankfein* (case no. 2017-0354), filed in May 2017 in

[2] Clovis held its annual meeting of shareholders on June 7, 2018, at which the proposal to ratify the new non-employee director compensation policy failed with 16,942,947 votes for and 22,928,795 votes against, according to the company's Form 8-K filed June 7, 2018.

the Delaware Court of Chancery, the plaintiff alleged that the annual compensation paid to non-employee directors was excessive, various proxy statement disclosures were incomplete or misleading, and stockholder approval of the stock incentive plans (under which the allegedly excessive compensation was paid) was void because of the proxy disclosures.

The defendants filed for a motion to dismiss before the *Investors Bancorp* decision. After that decision, in March 2018, the parties agreed to a settlement in which Goldman Sachs would:

- provide the plaintiff with draft copies of its 2018 proxy statement, to include specific disclosures about the new 2018 stock incentive plan in the proxy statement;
- for three years following the settlement, conduct, with an independent compensation consultant, an annual review of non-employee director compensation; and
- provide disclosure of these practices in its proxy statements.

Goldman Sachs also agreed to pay the plaintiff's attorneys' fees and expenses in the amount of $575,000. A settlement hearing is scheduled for September 2018.

<u>Case 3: OvaScience</u>. A lawsuit filed against and derivatively on behalf of OvaScience, Inc. ("OvaScience") reached a proposed settlement in June 2018. In the case styled *Fulton v. Dipp* (case no. 1:17-CV-00869), filed in June 2017 in the United States District Court for the District of Delaware, the plaintiff alleged the annual compensation paid to non-employee directors was excessive and a waste of corporate assets, constituting a breach of the directors' fiduciary duties. According to the complaint, the non-employee director compensation was an average of about $362,000 at the end of 2015, which exceeded the average compensation for non-employee directors at Fortune 50, the S&P 500, and a sample of large cap companies. OvaScience's stock is traded in the Russell Microcap Index.

The defendants filed a motion to dismiss in October, on which briefing closed in December. But before a decision on the motion was reached, the parties agreed to a proposed settlement on June 4, in which OvaScience would:

- Present a binding proposal to approve a new director compensation plan at the next stockholder meeting, establishing specific limits on overall compensation payable to non-employee directors ($300,000 for incumbent directors and

$600,000 for newly appointed directors[3]), and require all new equity awards to be subject to a mandatory holding period, all to remain in effect for at least three years;

- Agree to "be guided by" compensation practices of peer group companies and current best practices;
- Make certain related disclosures in its annual proxy statement; and
- Give stockholders the opportunity to vote on director compensation and options holding periods at least every three years.

The plaintiff is expected to file an application for attorneys' fees and reimbursement of expenses. The hearing on the motion for settlement is scheduled for August 2018.

Actions to Consider Now. In light of the *Investors Bancorp* decision and these litigation trends, companies may want to take some of the following actions:

1. Check Your Compensation-Setting Process and Disclosures. *Investors Bancorp* and the recent settlements noted above highlight the importance of having a robust decision-making process for setting director compensation levels. Directors may want to obtain the advice of independent compensation consultants and to consider their compensation levels and design in light of relevant marketplace practices. Public companies may want to take a fresh look at the disclosures about their director compensation program to ensure that they clearly communicate the rationale behind the compensation program design.

2. Consider Stockholder-Approved Compensation Limits. Companies should consider their risk appetite regarding potential claims of excessive director compensation. For companies that pay their directors more than their market median, have unusual director compensation circumstances, or are otherwise more concerned about stockholder claims, seeking stockholder approval of director compensation levels may be warranted.

    a. *Companies with Existing Stockholder-Approved Director Compensation Limits*. In recent years, a growing number of companies adopted director compensation limits in light of the case law development before *Investors Bancorp*. The limits are usually located in equity compensation plans that have been submitted to stockholders for approval. The plans often express the limit as a cap on the dollar value (or number of shares) of annual equity awards for each individual

[3] OvaScience held its annual meeting of shareholders on June 26, 2018, at which the proposal to approve the new non-employee director compensation policy passed with 12,250,924 votes for and 659,309 votes against, according to the company's Form 8-K filed June 26, 2018.

director, or a limit on the combined dollar value of annual cash and equity awards for each individual director, with the dollar value usually set within a relatively narrow range above current compensation levels, such as 2x to 4x current levels.

These limits are factually distinguishable from the limits considered in *Investors Bancorp*. But given the Court's analysis and holding, there is a heightened risk that the stockholder ratification defense will not protect director compensation decisions even within these stockholder-approved individual compensation limits if the decisions are challenged. Companies with these limits will face a choice the next time they are otherwise taking their equity compensation plan to stockholders for approval (e.g., when adding new shares), informed by their litigation risk appetite, to either:

- Leave the limit in place, as-is, until the courts further clarify the scope of the *Investors Bancorp* decision;
- Obtain stockholder approval of a revised compensation limit that more likely satisfies the *Investors Bancorp* standard, such as a formulaic plan design; or
- Eliminate any director compensation limit and trust in the director compensation process and decisions as being entirely fair to stockholders.

Even if the stockholder ratification defense cannot be invoked for an existing stockholder-approved limit under the *Investors Bancorp* standard, the existence of that limit could be a helpful factor in determining whether compensation decisions are equitable under the entire fairness standard.

b. *Companies That Have Not Yet Adopted Director Compensation Limits*. For companies that have not yet adopted a stockholder-approved director compensation limit, the choices are somewhat simpler. For more risk-averse companies, *Investors Bancorp* provides a roadmap for establishing a stockholder-approved director compensation plan that would more likely be shielded by the stockholder ratification defense. The best approach would probably be a formulaic design or a limit that is very close to existing compensation levels. Of course, this approach inherently limits director discretion, but such is the trade-off for the heightened protection against stockholder claims.

<u>Conclusion</u>. The expense for non-employee director compensation in the aggregate is likely only a very small portion of a company's general administrative expenses. But the spotlight that can be shined on those compensation levels and practices through stockholder-initiated litigation can be a major distraction and disproportionately costly. Given the recent trends noted above, companies should proactively ensure that they are following best governance practices in

setting director compensation levels, are clearly disclosing those decisions, and (in some cases) are having those compensation decisions approved by their stockholders.