Discourage Costly Stockholder Derivative Lawsuits by Obtaining Stockholder Ratification of Reasonable Limits on Non-Employee Director Equity and Cash Compensation

J. MARC FOSSE

For members of a board of directors who are also officers of the corporation, complying with securities and tax laws will also generally require that their compensation be approved by independent and disinterested non-employee members of the corporation's board. However, similar governance standards are not required by law when these non-employee directors approve their own compensation. In order to prevent potentially costly stockholder derivative suits challenging non-employee director compensation, Delaware corporations should consider obtaining stockholder approval for reasonable limits on non-employee director equity and cash compensation. For example, in *Calma v. Templeton*, a stockholder brought a derivative action in the Delaware Court of Chancery to challenge the excessiveness of restricted stock units ("RSUs") granted to eight non-employee directors of Citrix Systems, Inc. ("Citrix") under its 2005 Equity Incentive Plan. The stockholder claimed that the awards were excessive when combined with cash compensation received by the non-employee directors in comparison to compensation received by directors at certain of Citrix's peer companies. The plaintiff stockholder alleged that because the non-employee directors approved their own compensation, the RSU awards were "conflicted compensation" and the directors must establish the entire fairness of the RSU awards instead of relying on the business judgment presumption.

Normally, when a Delaware court reviews a stockholder's derivative claim that certain directors have breached their fiduciary duty by approving excessive compensation, there is a presumption that the business judgment standard applies. Under this standard, the stockholder plaintiff is required to show that the board's decision cannot be attributed to any rational business purpose. (This is also the test for corporate waste under Delaware law). However, if the plaintiff rebuts this presumption by showing that at least half of the directors that made the decision were not independent or disinterested, then the court reviews the decision under the entire fairness standard. Under that standard, the company has the burden to demonstrate to the court's satisfaction that the transaction was the product of both fair dealing and a fair price.

In *Calma*, the court found that the stockholder had rebutted the business judgment presumption because Citrix's compensation committee had approved its own compensation and that of the other non-employee directors. Citrix moved to dismiss the complaint based on the defense of stockholder ratification. Citrix argued that because the stockholders had ratified the terms of the

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found that the stockholders' approval of the equity plan was not ratification of the RSU awards. The court noted that based on the stock price for Citrix on the date of grant of the applicable RSUs, one million RSUs would have been worth over $55 million. The court found that this limit was not a reasonable stockholder approved limitation on the amount of director compensation that could be granted under the equity plan. Without the ratification defense, the court held that whether or not the compensation of the directors is excessive would be subject to review under the entire fairness standard and denied the motion to dismiss.

Citrix may ultimately be able to demonstrate to the court that the compensation paid to its non-employee directors would pass the entire fairness standard. However, it is more likely that the directors will settle the case to avoid costly litigation. The point is that once the stockholder derivative suit survives a motion to dismiss, the plaintiff will have leverage to exact a settlement from the company to avoid costly litigation. So how can a Delaware corporation place itself in a better position to prevail in a motion to dismiss? Stockholders should ratify meaningful limits on equity and cash compensation that can be awarded to non-employee directors.

In most equity compensation plans, the plans will already have certain per person limits on certain equity grants. For example, in order for compensation to qualify as performance-based compensation under section 162(m) of the Internal Revenue Code (the "Code"), the compensation must be subject to performance criteria that are approved by the stockholders. If the company places a per person limit on the compensation that can be granted, the company can have discretion to select from a range of pre-approved stockholder performance standards that must be re-approved by stockholders every five years. For this reason, most public companies have a per person limit on the performance-based awards that can be granted under the equity plan. The 1,000,000 share annual grant limit in the Citrix equity plan was probably included in the plan to comply with Code section 162(m), and then Citrix tried to argue that it was also a stockholder-approved limit on non-employee director compensation. A company stock option plan may also have a $100,000 limit on the amount of statutory stock options that can first become exercisable in any one calendar year to comply with section 422 of the Code. However, statutory stock options cannot be granted to non-employee directors, so this limit will also not apply as a reasonable limit to non-employee director compensation. As the above examples illustrate, just because a corporation's existing equity plans contain certain stockholder-approved grant limits, that does not mean that those limits will be "meaningful" limits on non-employee director compensation under Delaware law.

While the *Calma* decision did not specifically address cash compensation, it seems the reasoning in the decision would apply. We recommend that Delaware corporations evaluate their current compensation policies for non-employee directors and obtain stockholder approval for reasonable limits on the amount of compensation that directors can approve for themselves. By having stockholders adopt these reasonable limitations, stockholders should be discouraged from bringing future derivative suits similar to *Calma*.

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