Corporate Governance

Dealing With Director Compensation

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Due to a recent Delaware Chancery Court ruling,[1] the topic of director compensation currently is facing an uncharacteristic turn in the spotlight. Though it receives relatively little attention compared to its higher-profile cousin—executive compensation—director compensation can be a difficult issue for boards if not handled thoughtfully. Determining the appropriate form and amount of compensation for non-employee directors is no simple task, and board decisions in this area are subject to careful scrutiny by shareholders and courts.

The core principle of good governance in director compensation remains unchanged: Corporate directors should be paid fair and reasonable compensation, in a mix of cash and equity (as appropriate), to a level that will attract high-quality candidates to the board, but not in such forms or amounts as to impair director independence or raise questions of self-dealing. Further, director compensation should be reviewed annually, and all significant decisions regarding director compensation should be considered and approved by the full board.

The Citrix Case

Last month, in the case of *Calma v. Templeton*, the Delaware Chancery Court denied defendants' motion to dismiss a claim that Citrix Systems' board of directors had breached their fiduciary duties in awarding compensation to outside directors under a compensation plan that had been approved by shareholders.[2] The suit challenged awards made in three consecutive years to non-employee directors under the existing equity incentive plan, which had been approved by a majority of shareholders a few years earlier. Potential participants in the shareholder-approved plan included all employees, directors, and officers of Citrix; the plan contained only a sky-high limit of one million shares per participant per year (worth over $55 million at the time of the lawsuit) and no sub-limits based on the participant's position.

The Chancery Court determined that the entire fairness standard of review was applicable to the claim because the awards to the outside directors were made by the recipient directors themselves, and therefore the directors granting the awards were not disinterested: "[D]irector self-compensation decisions are conflicted transactions that 'lie outside the business judgment rule's presumptive protection.'"[3] The directors' primary defense was that the equity plan had been ratified by shareholders; however, in light of the lack of meaningful limits or specific guidelines for awards to non-employee directors, the Chancery Court found that shareholder approval of the plan as a whole did not constitute approval of the specific decision of the board to make the grants in question. The directors also asserted that the grants were in fact entirely fair because the company's director compensation practices were comparable to those of its peer companies; however, the defendants and the plaintiff differed as to which companies should be considered peers for this purpose. Citing factual questions as to the fairness of the stock awards, the Chancery Court found a sufficient basis to allow plaintiff's claim for breach of fiduciary duty to proceed.

The Chancery Court determined that the plaintiff had failed to state a claim for waste of corporate resources, on the basis that the compensation awards were not "so one-sided that no reasonable business person could conclude that the Company received adequate consideration."[4] The court did allow the plaintiff's claim for unjust enrichment to proceed, on the basis that, at this stage of the litigation, the claim was entirely duplicative of the claim for breach of fiduciary duty.

Directors can draw several important lessons from the Citrix case. First, with respect to conflicts of interest: If director compensation is not made pursuant to a shareholder-approved plan containing meaningful limits on director awards, where possible, directors should avoid being in the position of approving their own individual director compensation.[5] Second, with respect to shareholder-approved equity compensation plans: An argument for ratification will be bolstered by (1) realistic limits contained in the plan, (2) sub-limits for different categories of participants, with specific details as to the awards for directors,[6] and (3) fixed-value limits rather than fixed-share amounts. If, when faced with a challenge such as the one in the Citrix case, the board can establish shareholder ratification, a court will review the claim only for corporate waste, which is a very high threshold for a plaintiff to meet. Third, regarding compensation benchmarking: Because of the factual issues involved in determining a peer group and analyzing the various corporate practices of peer group members, benchmark data is unlikely to be sufficient to convince a court to grant a motion to dismiss. However, to provide protection against the possibility that a claim survives a motion to dismiss, it may make sense for the board to hire a compensation consultant to assist in constructing the appropriate peer group for benchmarks.[7] In turn, creating a strong record demonstrating a thoughtful decision-making process, and establishing an effective process for determining compensation awards, all by way of demonstrating the reasonableness of director compensation if the "entire fairness" standard were to be applied. The board and its consultant should re-evaluate the elements of director compensation, including the composition of the benchmarking group, regularly, if not annually.

The bottom line is that when a company seeks a shareholder vote on an amended or new stock plan that includes directors, appropriate and meaningful sub-limits for directors should be added. If a stock plan does not have effective, meaningful sub-limits for directors (or a stand-alone director plan does not provide for an effective. meaningful limit),[8] the board should retain a compensation consultant with sufficient expertise to establish the appropriate record for the board's decision in making individual awards, including the determination of the peer group and the process for determining the awards in the context of overall director compensation.

Director Compensation Elements

The role of directors has undergone a fundamental change since the turn of the 21st century. The Sarbanes-Oxley Act of 2002 and the New York Stock Exchange corporate governance listing standards, first adopted in 2003, emphasized director independence and created a new set of regulations regarding director expertise, oversight practices, and board structure. Since then, the requirements applicable to public company directors have increased in number and complexity. More recently, in the wake of the 2008 financial crisis, the role of the board has been under close scrutiny, and directors have faced greater challenges than ever before. Being a public company director now entails a far larger time commitment than it did two decades ago, and it carries greater risks. Concern over possible personal liability for directors has grown. Shareholder lawsuits naming directors as defendants are almost automatically filed upon the announcement of significant transactions or other major corporate events, and, as a result, cautious boards treat each material decision as if it will be the subject of litigation against both the company and them personally.

Along with the increased risk and responsibility inherent in a public board position, compensation for directors has modestly risen as well. According to one source, director compensation has grown by approximately 5 percent per year over the last decade.[9] Given that directors now are expected to devote more time to their individual directorships and that individual directors tend to serve on a smaller number of boards, the increase in overall compensation is not surprising. And just as the form of executive compensation has shifted over recent years, the form of director pay has followed suit. While compensation remains composed of both cash and equity, the mechanisms for compensating directors, and the forms of compensation, are gradually changing.

Historically, the cash portion of directors' fees included both an annual retainer and additional per-meeting payments for attendance at meetings. In the current era, when companies are required to disclose in their proxy statements whether their directors have attended at least 75 percent of board meetings, attendance is essentially mandatory. For simplicity, and to compensate directors' involvement overall rather than on an episodic basis, many companies have eliminated per-meeting fees[10] and instead increased the cash retainer.[11] In addition, some shareholders have criticized per meeting fees as incentivizing boards to have a greater number of meetings. Currently, at the largest companies, per-meeting fees comprise about 1 percent of total director compensation, while at the smallest companies, they comprise around 7 percent. The cash retainer ranges from 34 to 37 percent of total compensation among companies of various sizes. In addition, some companies provide additional compensation for committee work (which may be in cash or equity), ranging from 5 to 11 percent of total compensation, although separate compensation for committee service is declining.[12]

As with executive compensation, director compensation has tended in recent years to include a greater proportion of equity. The current mix is roughly 50 percent equity, broadly speaking, with larger companies delivering slightly over half of their director compensation in equity and micro companies slightly under.[13] Whereas equity formerly was often granted in the form of stock options, that has decreased across all size categories of companies, with a strong preference now for granting full-value awards such as restricted stock or restricted stock units. As with executive pay, the theory is that full-value awards create closer alignment of leadership and shareholder interests. It is common for companies to have a minimum stock ownership guideline for directors, which is typically three to five times the annual retainer.[14] Stock options are granted more frequently by smaller companies and in certain industries in which executive compensation also depends more heavily on option grants.[15]

It is also becoming standard for companies to determine their equity grants by reference to a dollar amount rather than a number of shares. This permits companies to stabilize the value annually by adjusting the number of shares on the grant date, thus eliminating uncertainty both for the directors and for the shareholders who may be approving the compensation plans in advance.[16] Equity grants to directors are typically made in restricted stock or restricted stock units, or outright grants. Performance-based awards are generally not used as they are seen to have the potential for compromising director objectivity.[17] In addition, some boards have added a post-vesting/exercise holding requirement, which decreases the accounting cost and either allows for grant of more awards (if awards are based on a dollar amount) or for the incurrence of lower expense (if a set number of awards is granted). Since directors tend to hold these awards anyway, this additional requirement is not viewed as onerous.

Benchmarking compensation practices against peer groups is a valuable tool, but, as evidenced in the Citrix case, it is not without its complications. Boards that intend to rely heavily on the practices of peer companies as a basis for their own are strongly encouraged to engage a compensation consultant to help determine the appropriate group and to periodically re-evaluate the composition of the group.

Influential proxy advisors also have taken positions on director compensation. Institutional Shareholder Services recommends a case-by-case vote on compensation plans for outside directors, based on the cost of the plans against the company's ISS-generated benchmark. ISS recommends a vote in favor of a plan if it contains (1) director stock ownership guidelines of a minimum of three times the annual cash retainer, (2) minimum vesting of three years for stock options or restricted stock, or deferred stock payable after three years, (3) a mix of cash and equity, with a five-year vesting or deferral requirement on the equity if the value of the equity is a majority of the director's compensation, (4) no retirement benefits or perquisites to non-employee directors and (5) detailed disclosure in tabular form for each non-employee director for the last fiscal year.[18]

Glass Lewis opposes performance-based equity grants to directors, but otherwise takes a generalized view that outside directors should receive "reasonable and appropriate compensation," with fees being competitive but not excessive. Glass Lewis has its own proprietary model to value equity plans compared to peer companies and uses its analysis to determine its recommendations on director compensation plans.[19]

Board Leaders, Special Committees

It is appropriate and customary for board leaders such as the lead or presiding director and committee chairs, as well as members of committees that have greater responsibility, to receive additional compensation in recognition of their more significant and time-consuming roles.[20] In the committee context, as for the entire board, there has been a shift from per-meeting compensation to increased annual retainer fees for board leaders and members of certain committees.[21] This format is not only simpler but also more suited to current forms of communication and technology; frequently, committee business is conducted less through in-person meetings but more through a series of conference calls. It is also important that compensation not differ so widely among directors that issues of fairness or factionalism arise. Additional compensation for particular directors or committees should be clearly tied to their additional responsibilities and should be approved by the entire board. As with director compensation generally, additional compensation arrangements should be reviewed annually by the full board.

When the board has occasion to create a special committee for a particular purpose, it is also appropriate and customary for some or all of the members of that committee to receive additional compensation for their efforts. Over half of all companies in a recent survey indicated that they pay a retainer to the chair of a special committee, whereas only about one-third pay a retainer to the members of the committee.[22] Whether or not a board elects to pay retainers to one or all members of a special committee—a decision that should be situation-specific and made by the board as a whole—we recommend that special committees be compensated by retainer rather than through per meeting fees. In some instances, the compensation arrangements for a special committee are put in place when the committee is established. This may make sense where the responsibilities and time requirements for the special committee are specific and well-defined. Based on our experience, it may make sense for the special committee's retainer to be determined by the full board after the committee's work is done, rather than at the outset, when it is unclear how long the special committee will be in existence or how much work will be required of the special committee members. Typically, special committee compensation is determined by reference to retainers paid to chairs or members of other standing committees.

Director Independence

While there is no requirement as to how the board determines director compensation, it is typical for the board to assign this task to either the compensation committee or the nominating/governance committee. If the task is assigned to a committee, any significant decision regarding director compensation should always be reviewed and approved by the full board before becoming final. Absent extenuating circumstances, the board should refrain from approving increases in both inside and outside director compensation at the same time, as doing so can create a conflict of interest for the entire board.[23] At all times, the board should be careful not to take actions that would compromise non-employee directors' actual or perceived independence and objectivity.

Director compensation is a thorny matter because it is the board itself that must determine the compensation of its members. Ideally, disinterested directors will determine compensation for other directors, and shareholders will ratify compensation plans with meaningful director-specific limits, but fundamentally there remains an element of self-interest that cannot be eliminated completely. The Citrix case represents a situation in which the line between fair compensation and self-dealing became blurred enough to require a full fairness inquiry, and elements of the decision can be useful to boards as they review their compensation practices. Despite pressures to minimize director compensation for appearances' sake, and though directors are not generally motivated to serve simply by the compensation received, it is nonetheless important for companies to reward directors fairly for their work and to provide compensation adequate to attract high-quality candidates.

Endnotes:

1. *Calma v. Templeton*, Case No. 9579-CB (Del. Ch. April 30, 2015) available at courts.delaware.gov/opinions/download.aspx?ID=223030.

2. Id.

3. *Calma v. Templeton*, at text accompanying n.54 (citation omitted).

4. *Calma v. Templeton*, at text accompanying n.122 (citation omitted).

5. For example, when a board approves a significant award to a single director in recognition of extraordinary service (such as a particularly active Non-Executive Chair), care should be taken to reflect in the minutes for the meeting that the recipient was recused from the deliberations leading to the grant and its approval.

6. Note that a plan must contain separate limits on the amount of stock options and stock appreciation rights, and separately on other types of "performance-based" compensation, which can be granted to any participant over a specified period of time, in order for grants intended to be exempt from the tax deduction limits of §162(m) of the Internal Revenue Code to qualify for the exemption. Note, however, that §162(m) does not apply to non-employee directors.

7. The board's consultant for director compensation could be the compensation committee's independent compensation consultant so long as the consultant's independence will not be impaired through such service.

8. For companies with plans that do not have specific director sub-limits, they may want to consider adopting equity stewardship limits that impose (albeit non-shareholder approved) limits or constraints on how director grants would be awarded in practice and that practically operate to constrain the broad discretion that might be afforded by existing shareholder-approved plans.

9. See Steve Pakela & John Sinkular, "Trends in Board of Director Compensation," Pay Governance LLC, April 13, 2015, available at corpgov.law.harvard.edu/2015/04/13/trends-in-board-of-director-compensation/ (reviewing in detail many of the trends in director compensation).

10. Jerry Edge, "Executive Compensation: The Professional's Guide to Current Issues & Practices," Windsor Professional Information (2004) at 239

11. Joe Mont, "Stock Bounces Boost Director Pay as Companies Debate Per-Meeting Fees," Compliance Week (Oct. 25, 2012) available at www.complianceweek.com/blogs/boards-governance/stock-bounces-boost-director-pay-as-companies-debate-per-meeting-fees#.VVuIwtJ0xjV.

This steady decline over the past few years can be attributed to several factors:

- Board work is more fluid in nature and is increasingly completed outside of formal meetings.
- The increase in remote communications has become normal for many boards, leading to questions as to what constitutes a formal meeting for which a fee should be paid (e.g., does a 30-minute single-purpose conference call constitute a board meeting?).
- The elimination of meeting fees promotes board compensation program simplicity and simplifies plan administration and communication.

When meeting fees are removed, they are generally replaced with an increase in the annual cash retainer or equity grant.

2014-2015 Director Compensation Report, National Association of Corporate Directors, available at www.nacdonline.org/DirectorComp (for purchase) (NACD 2014-2015 Report), at 15.

12. See NACD 2014-2015 Report at 15.

13. See id. at 17. "Micro" companies are defined as public companies with annual revenues of $50 million to $500 million.

14. See Pakela & Sinkular, supra note 9.

15. See NACD 2014-2015 Report at 18.

16. See id. at 20.

17. See Pakela & Sinkular, supra note 9.

18. Institutional Shareholder Services, 2015 U.S. Summary Proxy Voting Guidelines, at 49, available at www.issgovernance.com/file/policy/2015-us-summary-voting-guidelines-updated.pdf.

19. Glass Lewis, Proxy Paper Guidelines, 2015 Proxy Season, at 35, available at www.glasslewis.com/assets/uploads/2013/12/2015_GUIDELINES_United_States.pdf.

20. See, e.g., Semler Brossy, "Quick Picks: Lead Director Pay Creeps Up at Biggest Companies," Dialogue (May 11, 2015) ("Boards are increasing lead director pay to reflect increased responsibility and enhanced scrutiny. According to an analysis by Agenda of recent proxies filed by the 100 largest companies, six of the 29 companies that made changes to director pay raised pay for lead directors. In the first half of 2014, Agenda reported another six Fortune 100 companies made similar increases. Lead directors are increasingly involved in shareholder outreach efforts, and an increase in pay is another signal to shareholders that the lead director has an important and substantial role in managing the board").

21. See NACD 2014-2015 Report at 22.

22. See id. at 26.

23. See, e.g., *Tate & Lyle v. Staley Continental*, C.A. No. 9813, 1988 Del. Ch. LEXIS 61 (Del. Ch. May 9, 1988) (applying the intrinsic fairness test to the board's creation of a funding trust that would benefit both management and non-management directors upon a change of control).

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