SAY ON DIRECTOR PAY – IS THIS IN OUR FUTURE?

By Kevin Kuschel and Alissa Martin

Today's corporate directors are seeking higher pay and expanded compensation packages to meet the demands of the ever-changing business and regulatory environment, even though limited economic improvements and scrutiny over compensation have contributed to less-than-expected increases. While attracting and retaining corporate director talent has become increasingly complicated, pending litigation may further complicate director compensation planning and may make finding qualified directors more difficult. With little recent luck on Say on Pay lawsuits, rulings in the current case of *Calma v. Templeton* could result in increased plaintiffs' actions aimed at director compensation, as well as additional attention by shareholder advisory firms such as Institutional Shareholder Services, Inc. (ISS).

WHAT IS CALMA V. TEMPLETON?

Last year a court in Delaware denied a motion in *Calma v. Templeton* to dismiss a claim of breach of fiduciary duty based on Citrix Systems, Inc.'s equity awards granted to directors. The decision makes it clear that equity awards granted to directors cannot be justified under the business judgement rule: a presumption that in making a 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 interests of the company. Instead, under the entire fairness standard, the company must prove that the equity awards were determined in a consistent process that is both fair to the shareholders and the company itself. Although the awards were made under a shareholder approved plan — a fact the plaintiff does not argue — they do allege the individual limits within the plan do not represent a reasonable level and have resulted in directors receiving "excessive" compensation as compared to peers. The courts did not dismiss the case, but rather found that "the Company did not seek or obtain stockholder approval of any action bearing specifically on the magnitude of compensation to be paid to it non-employee directors."

The *Calma v. Templeton* case is followed by *Espinoza v. Zuckerberg*, a case that challenged the reasonableness of stock awards granted to non-employee directors. While *Espinoza v. Zuckerberg* settled, these two cases in particular are setting the stage for high level scrutiny of director compensation, with potential for substantive case law.

CITRIX'S DIRECTOR COMPENSATION — IS IT REASONABLE?

Citrix, similar to peers and the majority of the market, provides director's compensation through cash and equity. The prevalence of this structure is undeniable. However, the lawsuit focuses on three issues: 1) the individual share cap in the equity plan, 2) the equity portion of the compensation package, and 3) the total magnitude of compensation relative to peers.

1. Equity plans put forth to shareholder votes are very standard. Certain requirements must be met within these plans for tax deductibility compliance. One of these requirements is an individual award cap, which is usually set well above what the company is intending to provide for any individual. The lack of specificity outlined in Citrix's equity incentive plan related to director compensation, or more specifically award practices, is lacking in all public company equity plans, and **all** equity plans include these caps that exceed what is planned to be awarded.

2. Citrix currently employs a fixed share methodology, whereby sitting directors receive 4,000 shares of stock each year on the same schedule. Due to this methodology, the reported stock value changes each year based on the stock price at time of grant. As such, in the years in question, Citrix directors received stock valued at $339k, $283k and $253k for 2011, 2012 and 2013, respectively. The market trend has been a move away from fixed shares, with presently only 17% of large companies maintaining this structure[1].

   Although we at Longnecker & Associates are proponents of the fixed value award methodology (same value every year), we believe there is merit in Citrix's structure. As referenced above, the value of Citrix's director equity awards declines each year, which directly corresponds to Citrix's stock price in each of these years. Therefore, when the share price is down, and shareholders are feeling more pain, directors are making less. You could argue that by taking the same number of shares each year, Citrix directors are more aligned to shareholders than a company taking the same value in stock each year. Further, had Citrix used a fixed value approach, the dilution to shareholders would have been greater in later years.

3. The total value of director compensation at Citrix does exceed the peer group average in each year with the exception of 2013. However, Citrix was not the most highly compensated, as directors at Adobe, Amazon, Google, Intuit, LinkedIn and Salesforce were all paid more than Citrix in one or more of the years in question.

While the magnitude of value and the structure may not seem to be aligned to the market, it does not necessarily point to compensation being unreasonable or excessive. Many factors go into the setting of appropriate compensation, including the number of directors, hours spent on board work, difficulty of recruiting, experience level, etc. This is where business judgment becomes an important tool in setting compensation, because there is not a one-size-fits-all approach to director compensation.

WHAT COMES NEXT?

If these cases are any indication of the future, director compensation may become a hotter topic sooner than we thought. We have long predicted that ISS would soon take up this issue and begin to assess reasonableness similar to executive compensation, but it seems plaintiffs cannot wait any longer for ISS to blaze its path forward. Unfortunately, this will create a new normal when structuring director compensation, exposing directors to additional legal risks, and costing the company more money to mitigate this risk.

Regardless of how the court actually rules, it is likely director compensation will get extra attention in the coming months and years, specifically:

1. More lawsuits. Once plaintiffs' attorneys smell blood in the water, many new lawsuits will be filed. Settlements only make this worse, as attorneys will seek to file a baseless case in hopes of settling out for a few hundred thousand dollars. This occurred with plaintiffs' attorneys following executive Say on Pay and resulted in making a lot of money.

2. ISS attention. Although ISS has dabbled in director compensation, they have never fully committed to quantitative analysis, similar to their executive compensation model. However, the more negative attention director compensation receives, the greater likelihood ISS advances the timeline on implementing this practice.

3. Say on Director Pay. We already have executive Say on Pay, so the natural next step is director compensation. Assuming courts find in favor of plaintiffs, the probability of say on director pay increases.

In reaction, it will be important for directors to diligently review and maintain competitive and defensible compensation levels which show strong alignment to shareholders. This will be achieved through:

1. Third-party advice and assistance, including extensive market review
2. Implementation of market best practices
3. Education on "hot button" issues
4. Doing what is right for shareholders and the company

In the end, preparation will be key to mitigating potential lawsuits, no matter how egregious. The unfortunate truth is that through the law of unintended consequences, these plaintiffs will end up costing companies more money with lawsuits and advisor fees, as well as increase costs of directors and reducing the pool of qualified director candidates by increasing the risk of sitting on a board. **Now is the time to start. This is not one where you want to ever say "better late than never."**

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[1] 2014-2015 National Association of Corporate Directors Director Compensation Survey

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