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Recent Director and Executive Compensation Lawsuits Heighten Need for Robust Corporate Governance

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Client Alert

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Over the past two years, there has been an uptick in the number of lawsuits challenging director and executive compensation. Cases such as*In Re: Investors Bancorp*, *Stein v. Blankfein*, *Hertz v. Frissora* and, most recently, *Tornetta v. Musk* are setting new precedent and introducing novel legal theories. This alert highlights certain recent lawsuits in this area and sets out considerations for boards setting executive and director compensation in light of these cases.

Takeaways

- There has been an increase in the number of lawsuits brought by stockholders against directors and executives involving compensation matters, and plaintiffs continue to assert novel claims against boards in these cases.
- Courts are increasingly applying the entire fairness standard of review (in lieu of the more board-deferential business judgment standard of review), allowing these compensation-related suits to survive an initial motion to dismiss.
- When claims survive a motion to dismiss, claims are more likely to be settled, potentially resulting in significant attorney fees and negative publicity for companies.
- One company is seeking to clawback compensation paid to former executives on the basis that they set a wrongful "tone at the top" – a novel theory that, if successful, could change how companies design and enforce their recoupment or clawback policies.

Considerations/Action Items

Boards, management and their counsel should carefully review their company's current director and executive compensation policies and practices to confirm that they follow good governance principles.

Boards should review their process for setting director and executive compensation and ensure strong controls and procedures are in place. Courts are looking more closely than ever at the processes and procedures boards use in setting executive and director compensation – including focusing on such factors as the consideration of peer company compensation, whether an independent compensation consultant was engaged, past practice, the purpose of the compensation, whether meaningful director compensation limits exist and use of special, independent board committees where conflicts exist. Boards should carefully consider why and how compensation is set, including consideration of the appropriate rigor of performance targets, and clearly document their rationale behind setting compensation. Boards should further confirm that proxy disclosures accurately describe the board's compensation philosophy and process.

Directors most likely cannot absolve themselves from liability in self-dealing transactions by including waiver language in a stockholder-approved equity incentive plan. At least one court has indicated that including general absolution language within a discretionary stockholder-approved plan document, without more, cannot absolve directors of future challenges against breach of their fiduciary duties.

Boards should consider the "tone" of company management and review their company's whistleblower procedures. Boards should ensure that meaningful avenues exist for whistleblowers to raise concerns to top management and the board. Executives should also be on alert that aggressive management styles could potentially serve as a basis for compensation recoupment or litigation.

Boards should review their clawback policies. Boards should review their company's clawback policy for any needed amendments, specifically considering how recoupment tied to a wrongful "tone at the top" (which is the basis of a current lawsuit) or other negative company culture issues would play out. Many companies already are expanding clawbacks beyond the minimum financial restatement trigger required under applicable law to also cover other conduct that is or may be detrimental to the company, such as fraud or other misconduct and breach of restrictive covenants.

Boards should confirm that information that is relevant to setting executive compensation is disclosed to other directors. Directors should routinely consider if they are privy to information about the company or its executives that may affect executive compensation decisions and share such information with other directors responsible for making compensation decisions to better ensure that compensation is appropriately set.

Boards should consider whether large and/or atypical awards granted to executives who are also controlling stockholders should be approved by an independent, special committee and ratified by disinterested stockholders, so as to attempt to be eligible for business judgement review should the award ever be challenged. The court in a current lawsuit emphasizes the influence that controlling stockholders who are also executives can have on both the board and minority stockholders. Such perceived influence in the context of extremely large and/or atypical awards may lead to the application of the entire fairness standard of review (versus the business judgement standard) in a lawsuit, especially if such awards represent a significant departure from past company or peer practices.

Key Case Developments

In Re: Investors Bancorp [1] : Stockholders challenged equity awards valued at more than $51 million that were granted to company directors shortly after stockholder approval of a new equity incentive plan. The plaintiffs claimed that the awards were excessive in light of peer and prior company compensation and, contrary to proxy statement disclosures regarding the company's incentive plan, rewarded prior (not future) performance. The plaintiffs sought rescission of the awards and damages, including interest and attorneys' fees. On appeal, the Delaware Supreme Court applied the entire fairness standard, overruling the lower court's use of the commonly applied business judgment standard, and stated that the lower burden of an entire fairness review was appropriate where a plaintiff properly alleges breach of fiduciary duty – notwithstanding the existence of an overall maximum limit on non-employee director compensation within a stockholder-approved equity plan, among other items. The case settled in June 2019. [2] The settlement involved partial rescission of the challenged non-employee director awards, cancellation of the challenged executive director awards (as the parties could not agree to the appropriate amount to rescind) and payment of $7.9 million in plaintiff attorney fees. Following and apart from the settlement, the company granted new, substantial equity awards (which were less than the prior awards) under the incentive plan to the executive directors.

Stein v. Blankfein ***[3]*** : Plaintiff claims that the compensation paid to the non-employee directors of Goldman Sachs was grossly excessive ($600,000/year compared to an average of $350,000 at peers) and in breach of the board's fiduciary duty of loyalty (based on the assertion that the company had a lower net income and its directors attended fewer board meetings than their peers). The defendant directors moved to dismiss the complaint on the basis that the stockholder-approved plan pursuant to which the awards were granted absolved directors for breaches of self-dealing, absent bad faith, and that the plaintiff failed to plead that the compensation was unfair. The Delaware Court of Chancery applied the entire fairness standard, as laid out in *In Re: Investors Bancorp*, and denied the dismissal but noted that the plaintiff's arguments were weak. The court questioned whether stockholders could ever release directors in advance for unknown breaches of the duty of self-dealing, but stated that any such release would not be possible, at minimum, without expressly calling out that a vote on an equity incentive plan included approval of director absolution for any future breaches of duty. The case remains in litigation.

<u>*The Hertz Corp. v. Frissora*</u> ***[4]*** : Hertz seeks to recover $70 million in incentive payments and an additional $200 million in related damages from former executives, including its former CEO, CFO and GC on a novel theory that the fostering of an aggressive company culture led to the restatement of the company's financial statements in 2015. The company claims that by fostering an inappropriate "tone at the top," the defendants breached their duties to the company and triggered the company's clawback policy that permits recoupment for gross negligence and misconduct. This case is currently in litigation.

<u>*Feuer v. Redstone*</u> ***[5]*** *:* Stockholder challenged payments made to a CEO who was paid large salaries and bonuses (following historical pay practices) over a period of three years despite increasing incapacity. The plaintiff alleged that multiple directors knew of the CEO's declining health but failed to alert others on the board or consider the appropriateness of his compensation in light of his decreasing role at the company. On initial review, the Delaware Court of Chancery found, among other items, that the contribution of the CEO compared to his salary was "beyond the range of what any reasonable person might be willing to trade for such 'services'" and allowed the case to proceed in part. The parties settled in June 2019, [6] with the defendant directors agreeing to pay $1.25 million to the company (funded by insurance) in return for a release of the claim. The company also reimbursed certain attorney fees.

<u>*Tornetta v. Musk*</u> ***[7]*** *:* Stockholder challenges controlling stockholder and CEO's award of stock options that have a value of up to $55.8 billion, claiming breach of the CEO and board's fiduciary duties, unjust enrichment and corporate waste. Upon a motion to dismiss, the court dismissed the corporate waste claim but let the other claims survive. On the breach of fiduciary duty claim, the court applied the entire fairness standard of review because (i) the CEO is a controlling stockholder and (ii) the plaintiff adequately alleges that the board and minority stockholders were unduly influenced by the CEO in approving the award. In applying the entire fairness standard of review, as opposed to the business judgment standard of review, the court extended the analytical framework established in *In Re MFW Stockholders Litigation*, [8] which considers the extent to which an independent board committee has acted and a majority of the minority stockholders has approved an action involving a controlling stockholder. The court indicated that the company met the

majority of the minority stockholders vote requirement but failed to satisfy the independent, special committee condition. The case currently remains in litigation.

<u>City of Birmingham Relief and Retirement System v. Hastings</u> ***[9]*** *:* Plaintiff asserted that Netflix's 2015-17 performance targets were set to guarantee large executive bonuses, pointing to the fact that the targets were hit, but not exceeded, in seven out of eight performance quarters, and missed by only 1% in the eighth quarter. Plaintiff further claimed that, by setting the performance targets at levels that were known not to be "substantially uncertain," [10] the directors violated tax laws (despite there being no IRS investigation) in breach of their fiduciary duties. The United States District Court for the Northern District of California approved the defendants' motion to dismiss in March, but gave permission to the plaintiff to amend its complaint if it could show that the board knew of the misconduct. The parties recently reached a tentative, undisclosed settlement that has yet to be approved by the court.

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[1] *In Re Investors Bancorp, Inc. S'holder Litig.* , 2017 WL 1277672 (Del. Ch. Apr. 5, 2017), *rev'd*, 177 A.3d 1208 (Del. 2017).

[2] *See In Re Investors Bancorp, Inc. S'holder Litig.* , 2019 WL 2567855 (Del. Ch. June 21, 2019) (Trial Order).

[3] *Stein v. Blankfein* , Docket No. 2017-0354 (Del. Ch.).

[4] *The Hertz Corp. v. Frissora* , No. 2:19-cv-08927 (D. New Jersey).

[5] *Feuer v. Redstone,* 2018 WL 1870074 (Del. Ch. Apr. 19, 2018).

[6] *Feuer v. Redstone,* 2019 WL 2616855 (Del. Ch. June 25, 2019) (Trial Order).

[7] *Tornetta v. Musk,* Docket No. 2018-0408 (Del. Ch.).

[8] *See In re MFW S'holders Litig* ., 67 A.3d, 496 (Del. Ch. 2013)*, aff'd*, *Kahn* v. *M&F Worldwide Corp*., 88 A.3d 635 (Del. 2014). In *In Re MFW Shareholders Litigation*, the court held that the business judgement standard of review is appropriate in the context of a freeze-out merger when the merger is conditioned upon approval of both an independent board committee that fulfills its duty of care and an uncoerced, informed vote of a majority of the minority stockholders.

[9] *City of Birmingham Relief and Retirement System v. Hastings* , Docket No. 5:18-cv-02107 (N.D. Cal.).

[10] Prior to amendment in late 2017, Section 162(m) of the Internal Revenue Code of 1986, as amended, allowed companies to deduct executive compensation in excess of $1,000,000 if such compensation was "performance-based." One element of "performance-based" compensation required that the compensation be set at a time when the performance targets were "substantially uncertain."

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