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RECENT FACEBOOK SETTLEMENT OVER DIRECTOR PAY COULD SIGNAL MORE LITIGATION AGAINST DIRECTORS

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Executive compensation experts were unpleasantly surprised by the settlement in late January of *Espinoza v. Zuckerberg*, a case challenging the reasonableness of stock awards to Facebook's non-employee directors. The facts surrounding this settlement create concern that unless a company has a shareholder-approved plan with meaningful limits on both the cash and equity compensation that can be awarded to non-employee directors in a year, it faces a risk of being sued, particularly where the actual amount of compensation gives plaintiffs' lawyers a credible argument that pay is "above market."[1]

There are several reasons why *Espinoza* is concerning. First, the amount of the allegedly "excessive" compensation did not seem particularly large. Second, the plaintiff's lawyers are expected to receive attorneys' fees of $525,000 even though it appears highly likely that Facebook would have eventually prevailed because its controlling shareholder approved the transaction. Last, the settlement can be read to require a shareholder vote every time there is an increase in director pay, thus creating a precedent of a "Say-on-Director-Pay" standard. It should be noted that Frederic W. Cook & Co. has no knowledge of the facts in *Espinoza* outside the public filings.

In light of *Espinoza* and other recent cases involving director compensation we believe it prudent for corporations to consider adding specific director limits on both equity and cash compensation the next time the stock plan is presented to shareholders. Further, if the risk of litigation is determined to be potentially higher, consider submitting the plan for shareholder approval earlier than would otherwise be required.

Background to the Director Compensation Litigation

The threshold issue is whether a company can avoid discovery when a derivative action is brought on behalf of a corporation alleging that non-employee directors have breached their fiduciary duties by awarding themselves too much compensation. A common practice is to file a motion to dismiss the complaint prior to commencement of discovery, alleging that even if all the facts pled in the complaint are true, the complaint does not state a valid claim for relief. If a lawsuit can survive a motion

[1] We note that *Espinoza* was decided under Delaware law and the law of other states may differ with respect to the issues discussed in this bulletin.

to dismiss, the nuisance value of discovery means that a case may have significant settlement value, regardless of whether a defendant can eventually prevail.

It was this inability to get past a motion to dismiss that has brought to a virtual halt the lawsuits that arose in the wake of failed say-on-pay votes. What led to the majority of these cases eventually being dismissed at the pleadings stage was that the plaintiffs could not overcome the application of the business judgment rule. As interpreted by Delaware courts, this standard results in a case being subject to dismissal if any reasonable person could conclude from the facts pled that "the deal made sense."

Cases challenging non-employee director compensation differ from cases challenging executive compensation in a fundamental way. Non-employee directors have a direct interest in the amount of their own pay. Delaware courts have recognized this difference and repeatedly held that cases challenging director compensation do not get the protection of the business judgment rule. Absent such protection, it can be very hard to dismiss the case at the pleadings stage.

A number of recent cases have advanced an alternative theory for dismissal at the pleadings stage, which is that shareholder ratification of the company's stock plan served as ratification of the grants in question. While the Delaware courts have accepted this theory in principle, recent case law has repeatedly held that a general limit on the amount of shares that can be issued under the plan does not constitute shareholder ratification for purposes of director compensation. *See Calma v. Templeton*, CA No. 9579-CB (Del. Ch. April 30, 2015), and *Seinfeld v. Slager*, 2012 WL 2501105 (Del. Ch. June 29, 2012).

<u>The Facebook Facts</u>

The first fact about the Facebook litigation raising concerns for executive compensation professionals is that the current amount of director pay at Facebook is not particularly high on a relative basis for a company the size of Facebook. For example, as of January, 29, 2016, Facebook ranked sixth of the 12 largest U.S. public companies by market-cap value. Meanwhile, based on the most recent proxy statement data, the average pay (cash and equity) of Facebook non-employee directors of $386,000 ranked second of the 12, with the average pay of the third and fourth highest closely trailing at $367,000 and $363,000 (averages exclude directors serving as Board Chair and directors who served a partial year due to retirement).

While Facebook's current equity program appears to provide for annual equity grants worth $300,000, the challenged 2013 annual equity awards were higher due to the timing of the grants--$388,000 (this excludes a special grant to one new director). By way of contrast, the non-employee directors in *Seinfeld* each received restricted stock units worth $744,000, which brought their annual compensation to between $843,000 and $891,000. In *Calma* the program maintained by Citrix Systems, Inc. resulted in restricted stock units worth $339,000 being awarded to directors in the highest year. While $339,000 is obviously closer to the amounts involved in Facebook, Facebook is about 30 times the size of Citrix.[2] The *Espinoza* settlement thus acts as a signal that companies might not expect to escape being singled out just because they think their director pay program is reasonably sized. Unless

[2] For the sake of completeness, it should be noted that in September 2013 (when the director pay program was apparently adopted), Facebook was "only" a $122 billion market capitalization company, but still about 10 times the size of Citrix.

the proxy statement contains clear disclosure that non-employee directors are being paid at the median level of a peer group that itself is safe from attack, there seems to be potential for a lawsuit.

The second concerning fact is the $525,000 payday for the plaintiffs' attorneys for a case that may well have been won by the defendant. A settlement of this size could encourage some lawyers to methodically search the proxy statements of companies for director compensation amounts that deviate from the median amounts in survey data that is readily obtainable for companies of different sizes and in different industries. Plaintiffs may conclude that the recipe for escaping a motion to dismiss (and collecting large settlement dollars) is simply to plead that the director pay exceeded the median level in some survey.

Facebook's controlling shareholder approved the director pay program after the lawsuit was filed, expressing his approval in a deposition and an affidavit. Many legal experts would regard this as a complete defense. The court, however, held that his approval was ineffective because it was not contained in a written consent that complied with Section 228 of the Delaware General Corporation Law. The key problem appears to be that Section 228(e) requires that prompt notice of any written consent be given to the other Facebook shareholders. While there is no apparent reason why Mr. Zuckerberg could not sign another written consent at a time when notice of the consent could be contained in the annual proxy statement (thus avoiding the need for separate notice), Facebook historically files its proxy around April, which may mean that it would have had to undergo the distraction and expense of discovery until April unless it incurred the costs of a separate shareholder mailing. These facts may have convinced Facebook to settle, but some plaintiffs' attorneys will focus on the fact that a case which may well have been won got settled for $525,000.

The third concerning fact is that the settlement requires Facebook to present a proposal for shareholder approval at the 2016 annual meeting for an "Annual Compensation Plan" for directors, which "includes a specific amount for annual equity grants and delineates the annual retainer fees" going forward. It is not clear whether this reference to a "specific amount" means that shareholder approval will be required every time equity grants or annual retainers increase. While it is unclear what was intended, the ambiguity may result in plaintiffs' attorneys seeking settlements requiring annual votes for any change in director compensation. The case law treating shareholder ratification as a defense is less restrictive—shareholder ratification will be deemed to have occurred so long as a plan is approved with "meaningful" limits. As a general rule of thumb, many executive compensation lawyers believe that shareholder approved limits of two-to-three times the current compensation level are sufficiently restrictive. The settlement in *Espinoza*, however, may mean that corporations playing the litigation lottery could end up with a settlement requiring a vote each time the board wants to increase compensation.

<u>What Should Corporations Do?</u>

Unless a corporation thinks its proxy statement makes clear that director pay is at or below the median of a comparable peer group, it appears prudent to consider adding "meaningful" annual limits on director compensation in the stock plan when next going to shareholders for approval. The limits should apply to both equity and cash compensation, since the conflict-of-interest concerns in the director compensation cases apply equally to cash compensation.

Because stock plans run out of shares or usually need to be reapproved every five years to maintain tax deductibility under Internal Revenue Code section 162(m), a key question is whether the company should bring the plan to shareholders for approval sooner than it would otherwise. Two fact patterns may suggest seeking approval sooner: (1) non-employee director compensation is significantly higher than median; or (2), although non-employee director compensation is around median, company performance has been significantly below median, allowing plaintiffs to argue that median pay should only be paid for median performance. Fact patterns differ and there may be other reasons for not accelerating shareholder approval, but the settlement in the Facebook litigation suggests it may be prudent to consider the pros and cons of accelerated shareholder approval in consultation with legal counsel whenever either of these fact patterns exist.

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