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How Boards Can Guard Against Lawsuits Alleging Excessive Stock Awards

The Delaware court's refusal to dismiss certain director pay lawsuits puts boards on alert. Fortunately, there are steps companies can take to mitigate their risk of being a target.

In 2015, we were reminded yet again that director pay is often under some level of scrutiny by the plaintiffs' bar as new types of lawsuits emerge. The latest round of litigation centers on directors awarding themselves what are being called excessive amounts of equity awards, including restricted stock. While the number of these lawsuits filed is relatively small, they have gained attention because, in several of the cases, the Delaware court has denied motions to dismiss the suits and even indicated that the business judgment rule does not apply.

Background

These lawsuits stem from the inherent conflict of interest directors face when evaluating and setting their own pay each year. This conflict of interest was considered significant enough in one lawsuit this spring (Calma v. Templeton) that the Delaware Court overrode the business judgment rule— which presumes directors are informed and act in the best interests of the company.

Several lawsuits charge boards with breaching their fiduciary duty by granting large stock awards to directors, even though the awards were granted from shareholder-approved stock incentive plans. The Delaware court has ruled that shareholder approval of the incentive plan is not sufficient to override concern over excessive awards unless the shareholder authorization explicitly includes the non-employee directors' compensation.

In the Calma v. Templeton case, the court also rejected the defendant's claim that director pay was in line with its peer group; instead, the court questioned whether the companies in the peer group were too big and not a good representation for compensation benchmarking purposes.

Given the potential risk to directors of their time, money and reputation, we recommend boards evaluate their potential negative exposure and take mitigating steps to avoid or combat the possibility of these types of lawsuits.

Mitigating Steps

For companies that are not seeking shareholder approval of an equity compensation plan in the upcoming year, it makes sense to adopt a formal non-employee director compensation policy instead of amending an equity plan and seeking subsequent shareholder of the plan solely for this reason. This is particularly true for companies that have recently gone public with an evergreen provision in place. According to our research, 78.7% of technology and life sciences companies that went public over the past five years included evergreen provisions in the new equity incentive plans they adopted at the time of their IPO. While the existence of a director compensation policy setting out levels of equity or other director pay may not fully insulate a company from lawsuits, it will provide evidence for a program that is consistent with the market and subject to some reasonable limits.

We have also seen some companies begin to formally separate their employee equity incentive plans from non-employee director equity incentive plans. While this would be a departure from the trend of consolidating plans that we have observed in the past five years, in light of the recent litigation, companies may want to discuss the pros and cons of this approach with their advisers.

Other actions that companies should consider include:

- Setting appropriate non-employee director compensation limits in equity incentive plans based on reasonable benchmarks from the company's peer group, and obtaining shareholder approval of such limits
- Reviewing, at a minimum, the equity component of director pay more regularly to ensure grants are still within peer and industry norms
- Establishing and disclosing formal non-employee director compensation policies that are ratified by the full board
- Enhancing disclosure regarding the pay-setting process, including justification behind the peers used to evaluate the reasonableness of director compensation amounts (with particular sensitivity to the relative market cap, revenue and net income of peer companies)

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