Client ALERT

WOMBLE CARLYLE

Director and Executive Compensation Remains a Hot Topic for 2016

March 4, 2016

A series of recent Delaware Chancery Court and Securities and Exchange Commission ("SEC") decisions—coupled with anticipated SEC action to finalize the three remaining Dodd-Frank Wall Street Reform and Consumer Protection Act compensation rules—emphasize that director and executive compensation remains a hot topic for 2016. As a result of the heightened scrutiny of board decisions involving director or executive compensation, directors should consider whether their corporate governance practices could be enhanced by stepped-up periodic review of compensation practices and enhanced board and committee action documentation. The SEC's expectation of reimbursement of even de minimis compensation amounts following financial restatements born from misconduct, even if the CEO or CFO is not found to have participated in the misconduct, suggests that companies should closely examine their clawback policy if they have one, or consider implementing one if they don't. This client alert highlights for boards and management recent and pending developments in this area.

Delaware Developments Concerning Director Compensation

In the last year, Delaware courts have issued several rulings that suggest heightened scrutiny of board decisions involving director or executive compensation. First, with respect to director compensation, in April 2015, the Chancery Court held in *Calma v. Templeton* (the "Citrix case") that stockholder approval of an omnibus equity incentive plan would not constitute ratification of non-employee director compensation in the absence of specific or meaningful limits in the plan on the amount of compensation that may be awarded to non-employee directors. As noted in our earlier client alert, Delaware courts may apply the heightened "entire fairness" standard in analyzing non-employee director compensation approved by directors pursuant to a stockholder-approved equity plan without specific or meaningful director compensation limits.

More recently, in October 2015, the Chancery Court reviewed the equity awards and cash retainers paid to Facebook, Inc.'s non-employee directors in *Espinoza v. Zuckerberg, et al.* The suing stockholder criticized the compensation that Facebook paid to its non-employee directors, which was approximately 46% higher than the director compensation paid by its peer group. The Court declined to view Mark Zuckerberg's approval of the compensation in a deposition and in an affidavit as formal stockholder ratification of the self-interested transaction. Last month, as part of the settlement to resolve the dispute, Facebook agreed to (i) improve its corporate governance practices by providing for an annual review of non-employee director compensation with the assistance of an independent compensation consultant, (ii) submit for stockholder approval the 2013 non-employee director award grants and Facebook's annual director compensation program (which includes a specific amount for annual equity grants and delineates annual retainer fees) and (iii) pay plaintiff's attorneys' fees to settle the lawsuit. Although it remains to be seen whether other companies will voluntarily submit director compensation practices for stockholder

approval, at a minimum, companies should consider whether their corporate governance practices could be enhanced by stepped-up periodic review of director compensation practices.

Delaware Developments Concerning Executive Compensation

Last month, the Chancery Court determined that a stockholder may inspect Yahoo! Inc.'s books and records—including, potentially, any relevant emails[1] from CEO Marissa Mayer and Yahoo's compensation committee members if such individuals chose to use a personal email account to conduct Yahoo business, in addition to any emails from their Yahoo corporate accounts—to investigate alleged excessive compensation to Yahoo's former COO, Henrique de Castro, assess the independence of the compensation committee and investigate the circumstances surrounding Mr. de Castro's departure. The Court focused on the record established by the stockholder on the basis of publicly available materials and information supplied by Yahoo, which indicated that Ms. Mayer "failed to provide material information to the Committee during the early stages of the hiring process…while seeking the Committee's blessing for a large compensation package that the Committee's compensation consultant regarded as 'generally more than the data supported.'" The Court was also troubled by the allegation that "Mayer provided inaccurate information to the Committee about the terms of the [offer letter when asking them to approve a change to the COO pay package], and that the Committee agreed to the change based on the inaccurate information Mayer provided." The Court also observed that Ms. Mayer made additional changes to the final offer letter that materially increased Mr. de Castro's potential compensation, and that such changes did not appear to have been approved by the Committee. Finally, the Court agreed with the stockholder that the circumstances surrounding Mr. de Castro's termination without cause raised significant issues, as it appeared that a for-cause alternative may have been available. The Court also criticized the directors for their apparent "tangential and episodic" involvement, and uncritical acceptance of Ms. Mayer's statements and lack of questions surrounding Ms. Mayer's decision to terminate Mr. de Castro's employment without cause, when the Court suggested that Mr. de Castro failed to perform at every point during his brief tenure at Yahoo.

Practical Considerations When Engaging in Director and Executive Compensation Transactions

While the Citrix case is currently pending, and Yahoo last week appealed the Court's order that it must show documents connected to the employment of Mr. de Castro to Yahoo's suing stockholder, from a practical perspective, when a plaintiff's claim survives a motion to dismiss or the plaintiff clears the hurdle for a Delaware statutory books and records demand, litigation costs tend to rise substantially and the plaintiff has substantial leverage to extract a favorable settlement, including payment of attorneys' fees. A common theme has emerged from the Citrix, Facebook and Yahoo decisions: Process is critical

[1] The Court held that emails and other electronically stored documents are within the scope of "corporate books and records," and clarified that management and board members' emails would include emails from any personal accounts that management and board members may have used to conduct business on behalf of the company. For more information about the reach of a books and records inspection request in our increasingly digital age, *see* Francis G.X. Pileggi, Kevin F. Brady & Jill Agro, *Inspecting Corporate "Books and Records" in a Digital World: The Role of Electronically Stored Information*, 37 DEL. J. CORP. L. 163 (2012), available here.

in making decisions that involve director and executive compensation. In the Yahoo case, Vice Chancellor Laster stated that "[a] board cannot mindlessly swallow information, particularly in the area of executive compensation." As we await resolution of the pending Citrix and Yahoo cases, we recommend that companies consider the following actions when making director and/or executive compensation decisions:

- Boards and compensation committees should act reasonably and thoughtfully in setting director and executive compensation, using appropriate, rigorous and objective peer group data and outside advisers, including independent compensation consultants.

- Boards and compensation committees should remain involved and engaged in the hiring and termination of executives and exercise their own business judgment in approving an executive compensation transaction.

- Well-written minutes should document board and committee actions related to director and executive compensation. Board members and management should be cognizant that, under certain circumstances, their personal email accounts and other electronically stored documents may be subject to inspection or discovery, to the extent such accounts and documents relate to the issue at hand.

- A company planning to seek stockholder approval of an equity compensation plan in which directors participate should consider including a meaningful or specific limit on non-employee director compensation. Although, according to the National Association of Stock Plan Professionals/Deloitte Consulting 2014 Domestic Stock Plan Administration Survey, 77% of respondents said their plans did *not* include a limit on grants to non-employee directors, in our experience, more companies are adding non-employee director equity compensation limits, particularly when stockholders will be voting on the equity plan for other reasons.

- A company contemplating an increase to the compensation granted to non-employee directors should consider whether to obtain stockholder approval of specific amounts of or limits to director compensation, and if approval is not sought, provide a reasonable and thorough explanation for the change in director compensation in its proxy statement.

SEC Enforcement Actions under Section 304 of Sarbanes-Oxley Target Executive Compensation

Dodd-Frank was signed into law in 2010. More than six years later, guidance on several of the law's executive compensation provisions is still making its way through the regulatory pipeline, and regulations to guide companies in complying with another provision—the CEO pay ratio rule—have only recently been finalized. While we await final regulations (i) requiring pay versus performance disclosure, (ii) disclosure of hedging policies and (iii) adoption and disclosure of clawback policies, the SEC has continued to demonstrate its willingness to bring enforcement actions under Section 304 of the Sarbanes-Oxley Act of 2002 ("SOX") against CEOs and CFOs who fail to reimburse companies

following an accounting restatement due to material noncompliance with the securities laws, even for de minimis amounts. Section 304 requires the CEO or CFO of any issuer required to prepare an accounting restatement due to material noncompliance with the securities laws as a result of misconduct to reimburse the issuer for (i) any bonus or incentive-based or equity-based compensation received by that person from the issuer during the 12-month periods following the false filings, and (ii) any profits realized from the sale of securities of the issuer during those 12-month periods.

Most recently, last month, the former CFO of Marrone Bio Innovations, Inc. ("MBI") settled an enforcement action brought by the SEC in connection with misstated revenues at MBI. Even though the SEC did not allege that the former CFO had personally participated in the misconduct giving rise to the misstatement, the CFO received bonuses tied to MBI's achievement of certain revenue targets during the periods following the filings containing the financial results that MBI had restated. In the settlement, the former CFO of MBI agreed to cease and desist from committing or causing any violations of Section 304 of SOX and reimburse $11,789 to MBI.

Also last month, the SEC announced an investigation that found Monsanto Company had violated accounting rules and misstated company earnings by improperly accounting for rebates. Monsanto agreed to pay an $80 million penalty and three accounting and sales executives agreed to pay penalties ranging from $30,000-$55,000. Notably, the SEC found no personal misconduct by Monsanto's CEO and former CFO, who reimbursed Monsanto $3,165,852 and $728,843, respectively, for bonuses and stock awards they received during the periods when the accounting violations were committed. Therefore, since the executives had reimbursed the company for the compensation, the SEC opted not to pursue a clawback action under Section 304 of SOX.

We expect the SEC to finalize rules related to pay versus performance, hedging and clawbacks in the near future. Until then, the SEC's enforcement actions against Marrone Bio Innovations and Monsanto indicate that the SEC will continue to closely monitor accounting restatements and use its power under Section 304 of SOX to pursue clawback actions against CEOs and CFOs who received compensation or profits that are subject to recoupment under SOX. Companies, and their CEOs and CFOs, may avoid clawbacks (and related adverse publicity) if CEOs and CFOs reimburse the company for compensation or profits received by them on the basis of financial results that are subsequently restated. The SEC's actions suggest that no clawback amount will be too small, and it will not matter if the CEO or CFO is found to have committed no personal misconduct in connection with the material misstatements.

Contact Information

If you have any questions about the issues discussed in this alert, please contact Vivian L. Coates, the principal drafter of this client alert, at vcoates@wcsr.com, or you may contact the Womble Carlyle attorney with whom you usually work or one of our Corporate and Securities attorneys.

Womble Carlyle client alerts are intended to provide general information about significant legal developments and should not be construed as legal advice regarding any specific facts and circumstances, nor should they be construed as advertisements for legal services.