Director Compensation Decision Subject to "Entire Fairness" Standard

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The Delaware Court of Chancery (the "Court") recently issued a decision that is likely to subject director compensation to increased judicial scrutiny, making it easier for shareholders to bring suits against companies for issues regarding their director compensation. In Calma v. Templeton, the Court denied the defendant's motion to dismiss a claim that members of Citrix Systems, Inc.'s ("Citrix" or the "Company) board of directors breached their fiduciary duties in awarding themselves equity compensation under the Company's shareholder–approved equity incentive plan. In particular, the suit challenged restricted stock unit awards made to eight non–employee directors under the Company's equity incentive plan. Potential beneficiaries under the plan included Citrix's directors, officers, employees and consultants. The plan imposed a limit of one million shares per participant per calendar year (worth approximately $55 million at the time of the lawsuit).

Courts generally apply the business judgment rule to director compensation plans that are ratified by the corporation's shareholders. In Calma, however, the Court held that the applicable standard of care was the entire fairness standard because the shareholder–approved incentive plan did not have "meaningful" limits on the total compensation that the directors could have potentially received. Put another way, the Court agreed with the plaintiff's argument that shareholder approval of a plan with sky–high annual limits was not sufficient to establish a ratification defense.

Although the Calma decision deals solely with equity compensation, the Court's reasoning potentially implicates cash compensation as well. Given the potentially broad implications of the Calma decision, Delaware corporations and directors of Delaware corporations should consider amending existing director compensation plans to include meaningful limits on outside director compensation.

The SEC Proposes Clawback Policy Rules

Pursuant to section 10D of the Securities Exchange Act of 1934 (the "Exchange Act"), as added by section 954 of the Dodd–Frank Act, the Securities and Exchange Commission ("SEC") proposed rules regarding compensation clawback policies for publicly traded companies. The proposed rules would require companies to recover incentive–based compensation paid to executive officers in cases of material non–compliance with any financial reporting requirement under the securities laws. More specifically, the proposed rules would require recovery of compensation from any current or former executive officer who received incentive compensation during the three most recently completed fiscal years immediately preceding the date on which the company is required to prepare an accounting restatement to correct a material error.

For the purposes of the proposed rules, incentive compensation is defined as compensation granted, earned or vested, based wholly or in part on the attainment of any GAAP financial reporting measures. GAAP financial reporting measures are those that are based on the accounting principles used to prepare a company's financial statements, including any financial measures derived from such information, the company's stock price, or the company's total shareholder return.

The SEC rules propose a definition of an "executive officer" that is substantially similar to the definition of "officer" under section 16 of the Exchange Act. The definition specifically includes the issuer's president, principal financial officer, principal accounting officer, any vice–president in charge of a principal business unit, division, or function, and any other person who performs policy–making functions.

The proposed rules have been met with sharp criticism from observers and members of the SEC, alike. Accordingly, interested parties are likely to submit significant comments regarding the proposed rules, which could delay the adoption of the rules beyond next year's proxy season. Nonetheless, companies should use this time to re–examine their current clawback policies and be prepared for when the rules, in final form, are adopted.

SEC Proposes Rule on Hedging Transaction Disclosures

Earlier this year the SE proposed a rule regarding hedging policies for publicly traded companies, as required by Section 955 of the Dodd–Frank Act. The proposed rule would require public companies to disclose whether its employees and directors are permitted to hedge against the decline in value of company equity securities.

Although most public companies have hedging policies and disclose this policy in their proxies, this development deserves the attention of all public companies. The proposed rule would expand the definition of hedging, which is currently limited to purchasing financial instruments, to include all transactions that are designed to have the effect of offsetting a potential decrease in the market value of company equity securities. Further, the proposal would extend the disclosure requirement to a broader population by covering all employees, including officers and directors. As a result, some transactions that would not have been a hedging transaction under an existing hedging policy would be considered a hedging transaction under the proposed rule. If the proposed rule is adopted in its current form, many public companies will have to decide whether they are going to update their hedging policies to prohibit all of the newly covered transactions or disclose that they permit certain forms of hedging.

The proposed rule does not require public companies to adopt a hedging policy, or prohibit hedging; it only requires that they disclose any hedging policy that is in effect. Public companies that permit certain classes of employees or directors to participate in hedging transactions must disclose the categories of persons who are permitted to hedge and the persons who are not. Similarly, public companies must disclose the categories of hedging transactions that they permit and those transactions that they prohibit.

Shareholder Activism on the Rise in 2015

One of the most significant developments to emerge from the 2015 proxy season is the uptick in shareholder activism, which was highlighted by initiatives calling for increased proxy access. As shareholders continue to push for increased influence in proxy statements, proxy access initiatives are likely to remain a paramount issue for public companies and are likely to have implications in future proxy seasons.

Leading up to the 2015 proxy season, a group of institutional investors, led by the New York City Comptroller, came together to launch the "Boardroom Accountability Project," an effort aimed at submitting proxy access proposals to various public companies. The proposals request a bylaw to give shareholders who meet a threshold of owning three percent of a company for three years or more the right to list their director candidates, representing up to 25 percent of the board, on a given company's proxy. In the wake of the Boardroom Accountability Project, similar proposals were supported by BlackRock, Vanguard, TIAA–CREFF, CalPERS and CalSTRS. In all, the coalition of shareholder investors submitted over 100 proxy access proposals to 75 companies in 2015.

Rather than include proxy access proposals, many companies had planned to submit a conflicting (and more restrictive) proxy access proposal and exclude the shareholder proposals pursuant to Rule 14–a8(i)(9), which permits companies to exclude proposals that "directly conflict" with a management proposal. In response to shareholder outcry, the SEC suspended the relief granted under Rule 14–a8(i)(9), pending further review.

The SEC's refusal to grant no–action letters under Rule 14–a8(i)(9), coupled with the increasing number of proxy access proposals, has given way to widespread uncertainty among public companies. The confusion will likely remain through the 2016 proxy season. As companies and boards of directors develop strategies to deal with various issues during the 2016 proxy season, they should be sure to pay special attention to proxy access proposals.

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