

# Director and Executive Compensation in Today's World

Research Triangle Chapter, NACD  
Directors College Curriculum  
April 25, 2009

Jamison H. Hinkle  
Smith Anderson Law Firm

# Today's Compensation World: High stakes and getting higher

Executive compensation is under increasing scrutiny from:

- SEC and other regulators; stock exchanges
- Congress and the President
- Media
- Corporate governance and institutional investor groups
- Special interest groups
- Shareholders
- Plaintiffs' lawyers

# Are we on the verge of an explosion in shareholder lawsuits against directors over executive compensation matters?

- April 20, 2009—Service Employees International Union (SEIU) sent letters to 29 major financial services firms demanding that directors recover \$5 billion in incentive compensation amounts paid out based on the initial performance of derivatives and other investments whose values have since been written off; no lawsuit filed yet but “demand letters” such as this are a condition to bringing shareholder derivative suits.
- *In re Citigroup Inc. Shareholder Litigation* (Feb. 2009)—the Delaware Chancery Court generally reaffirmed the business judgment rule noting that directors’ oversight duties do not require them to predict the future or correctly evaluate all business risks; the court, however, notably did not dismiss plaintiffs’ claim that certain defendants could be liable to Citigroup for corporate waste for approving a multi-million dollar benefit package for Charles Prince who plaintiffs claim was largely responsible for the problems.

## Shareholder suits over compensation matters (cont'd)

- *Valeant Pharmaceuticals International (formerly ICN Pharmaceuticals) v. Jerney* (March 1, 2007)—Delaware Chancery Court found that board member violated his duty of loyalty in approving excessive, self-interested bonuses without the advice of an independent committee, expert or counsel.
- Ongoing review and second-guessing of retention bonuses and other board compensation decisions in Delphi and similar bankruptcy cases.
- Louisiana Municipal Police Employee Retirement System's March "books and records demand" against Chesapeake Energy in Oklahoma state court to review corporate records and documents to determine if Board's approval of \$75 million bonus to the CEO was proper.

## Compensation Committee Directors as Fiduciaries

- Like other director decisions and activities, compensation decisions by members of a board compensation committee will generally be afforded broad deference under the *business judgment rule*.
- Under the business judgment rule, directors' decisions are generally presumed to have been made in good faith and taken in best interest of the company unless plaintiffs can prove that the directors have not satisfied their *duty of care* or *duty of loyalty*.

# Compensation Committee Directors as Fiduciaries (cont'd)

## *Satisfying Your Duty of Care*

- Plaintiffs must generally show a director's actions have risen to the level of "gross negligence" for the failure to constitute a breach of duty of care. Per *In re The Walt Disney Co. Derivative Litigation*, mere negligence while acting in "good faith" should not result in a breach of duty of care.
- To satisfy duty of care, directors must take reasoned and informed decisions after due deliberation and consideration of relevant materials, including input from external advisors, etc.
- For compensation matters, this requires understanding the purpose and general operation of plans and programs, the related costs and potential payouts across different scenarios, and possibly a general understanding of how new or additional benefits impact overall compensation levels.
- Directors are not required to always be correct, "predict the future," or establish perfect pay for performance metrics or other compensation tools.

## Compensation Committee Directors as Fiduciaries (cont'd)

### *Satisfying your Duty of Loyalty*

- General duty to act solely in the best interests of the company.
- Directors should avoid “self-dealing” transactions or transactions resulting in some improper or indirect financial benefit to the director that does not benefit the corporation or its shareholders.
- If self-dealing is found, courts will ignore the presumption of good faith afforded by the business judgment rule and require directors to prove that the actions were taken in “*entire fairness*” to stockholders from both a process (“*fair dealing*”) and price (“*fair price*”) perspective.
- How to handle establishment of director compensation; approving individual contracts or arrangements between a director and the company?

## Compensation Committee Directors as Fiduciaries (cont'd)

### *Heightened fiduciary requirements in defensive or other special situations*

- Compensation actions taken and programs adopted as takeover defensive measures are subject to a heightened standard of review.
- Under the *Unocal* review standard, directors are required to show:
  1. They had “reasonable grounds for believing that a danger to corporate policy and effectiveness existed” and
  2. The measure taken was “reasonable in relation to the threat posed.”
- Takeaways: establish takeover defenses and change in control or similar compensation programs or elements prior to actual takeover or change in control event.

# Good Faith and Duty of Care—From Theory to Practice

- Conducting thorough Compensation Committee meetings and developing appropriate compensation programs is only part of the process.
- Discharging your duty of care and your duty of loyalty may ultimately only be helpful if you document it for later reference.
- Keeping thorough and complete minutes of all Compensation Committee meetings and actions is not only one of the best deterrents to potential lawsuits over compensation matters, but also one of the best evidentiary defenses for winning the case (and avoiding potential personal liability as a director) if a lawsuit should be filed.
- Discharging fiduciary duties (or at least defending against fiduciary breach claims) is frequently more about process or form than the substance (and accuracy) of the final decision.

# Good Faith and Duty of Care—From Theory to Practice (cont'd)

## *Developing Excellent Compensation Committee Minutes*

- One view—and historically a fairly common one—is that the shorter and more general a recitation of committee actions, the better.
- At a minimum, the minutes should reflect the topics discussed and final decisions taken as well as reflect that the committee sought and reviewed all information it deemed relevant and appropriate under the facts and circumstances.
- My recommendation, however, is that minutes go beyond this and actually demonstrate the committee's discharge of its duties by providing a summary of the discussions, the key issues debated, questions or concerns raised, the amount of time devoted to the discussion, the review of relevant materials and outside advice, consideration of any cost analyses or financial modeling, and the rationale the committee used in reaching its final decisions.

# Good Faith and Duty of Care—From Theory to Practice (cont'd)

## *Developing Excellent Compensation Committee Minutes*

- Although detailed minutes are recommended, they need not (and should not) read as a transcript of the meeting.
- There are likely to be certain times or topics when less is more and it may be better for the minutes not to include a complete discussion of concerns or issues.
- Of course, recommendation of detailed rather than perfunctory meeting minutes presupposes that the Committee holds appropriate meetings and affords sufficient time and opportunity for a full and thorough discussion of compensation related matters.

# Good Faith and Duty of Care—From Theory to Practice (cont'd)

## *Developing Excellent Compensation Committee Minutes*

- From prior *Disney* and *Cendant* litigation, we know courts will examine meeting minutes to evaluate the committee's fiduciary practices and procedures, including:
  - Whether draft agreements, plans, or other documents were provided to the committee prior to the meeting for review and consideration.
  - Whether members asked questions or sought additional information in connection with the committee's review (and approval) of a particular agreement or program.
  - Whether compensation consultants or other experts or advisors (both internal and external) were involved in the meeting or otherwise consulted.
  - The amount of time the committee devoted to a particular topic.
  - The committee's analysis of potential costs to the company and the overall level of compensation and benefits for executives as a result of plans under consideration.

# Everything I Needed to Know To Be an Excellent Committee Member I Learned From Youth Soccer

- **It's Not Whether You Win or Lose, It's How You Play the Game!**
  - Nobody can guarantee results, but you can guarantee input and effort.
  - Discharging fiduciary duty is about process, covering the fundamentals, and controlling what you can; it is not about results or outcome of particular decisions.
  - That said, winning is better than losing.
  - The more (and harder) you practice, the luckier you get.
- **Know, understand, and respect the rules of the game!**
  - Understand the purpose and basic operation of your compensation plans and programs.
  - Know and understand general regulatory, tax, and legal requirements of various compensation programs.
  - If you don't understand, do not be afraid to ask.
  - The rules can change; practices evolve; education is a continuous process.

# Everything I Needed to Know To Be an Excellent Committee Member I Learned From Youth Soccer (cont'd)

- **Don't wait for the game to come to you!**
  - The best compensation committees are proactive, not reactive.
  - Stay abreast of changes and enhancements; resist fads.
- **Instinct and common sense are some of your best tools!**
  - If a benefit or arrangement does not seem fair or appropriate, don't let it slide.
  - Each company is different; the most common compensation programs or the programs of the largest or most well-known companies may not be best for your company.
- **It's a team sport!**
  - Develop and tap into the experience and expertise of a broad team.
  - Utilize directors' experience in other settings (but adapt to your circumstances).
  - Consult with directors, executive officers, company HR and finance officials, compensation consultants, accountants, and even lawyers.

# Questions?

Jamie Hinkle

Smith, Anderson, Blount, Dorsett,  
Mitchell & Jernigan, L.L.P.

150 Fayetteville Street, Suite 2500

Raleigh, North Carolina 27601

(919) 821-6686

[jhinkle@smithlaw.com](mailto:jhinkle@smithlaw.com)