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ALERT MEMORANDUM

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Delaware Chancery Court Revisits the Topic of Fiduciary Duties of Directors in Approving Senior Executive Compensation Packages

The Delaware Court of Chancery's recently published opinion in *Amalgamated Bank v. Yahoo!, Inc.*[1] (the "Opinion") provides a reminder for directors about the importance of process in satisfying fiduciary duties when evaluating and approving executive compensation packages. In the Opinion, which deals with Amalgamated's demand under Section 220 of the Delaware General Corporation Law to inspect certain books and records of Yahoo! in connection with the hiring and firing of its Chief Operating Officer, Vice Chancellor Laster discusses practices that should be routine in a board's review of executive compensation proposals and highlights procedural pitfalls that have been noted in numerous Delaware law decisions dating back at least to the series of cases involving compensation practices at Disney beginning more than a decade ago.

Background of the Case

Shortly after she took over as Yahoo!'s CEO, Marissa Mayer determined to hire Henrique de Castro, with whom she had worked at Google, as her Chief Operating Officer and number two executive. On September 12, 2012, at a meeting of the Board's Compensation and Leadership Development Committee (the "Committee") Mayer raised the fact that she was "in discussions with a person to take the number two role" but did not identify de Castro by name. Mayer generally described the terms of the candidate's expected compensation package, and the Committee authorized her to continue negotiations, "subject to Committee review of the actual contract."

On September 23, 2012, Mayer provided the Committee with a term sheet summarizing the candidate's compensation package. On September 24, 2012, Mayer informed the Committee that the candidate was de Castro, and presented an offer letter tracking the term sheet that the Committee had reviewed the previous day. The Committee approved the offer letter and authorized Mayer to continue negotiations, but retained control over "material changes."

Vice Chancellor Laster describes and analyzes the terms of the offer letter in detail, thereby emphasizing the complexity of its provisions, and cites to academic critiques of the "increasing complexity of management compensation arrangements." He notes that the Committee "did not receive any materials that illustrated the complex interrelationships among the various compensation components or the amount of compensation they generate in particular scenarios." In particular, Vice Chancellor Laster focused on the various equity awards

[1] C.A. No. 10774-VCL (Del. Ch. Feb. 2, 2016), and available here.

to be granted to de Castro and the effect a subsequent termination of employment would have on such awards. In evaluating this aspect of the offer letter, Vice Chancellor Laster created a chart demonstrating the percentage of each type of equity award that would accelerate and vest, as well as the effective percentage of the total equity awards that would be received, if de Castro was terminated without cause after certain periods of time. He notes that the Committee did not have the benefit of such a chart.

Over the course of negotiations with Mayer, de Castro sought several changes to the offer letter that would accelerate vesting of a larger number of certain equity awards if he was terminated without cause by (i) extending the "tail period" for those awards from six to twelve months (i.e., accelerating awards that would have otherwise vested during the twelve months following the date of termination rather than during the following six months) and (ii) deleting provisions that would have capped the percentage of awards that could vest. The Opinion states that at a Committee meeting on October 13, 2012, at which Mayer asked the Committee to approve the deletion, she incorrectly described the terms of the offer letter, resulting in the Committee's failure to vote on the tail period extension. Vice Chancellor Laster again points out that the Committee "did not receive any materials that attempted to quantify the effect of the changes or illustrate how they altered the compensation payouts under different scenarios."

The final offer letter reflected a deletion of the cap—which had been approved by the Committee—and an increase in the tail period—which had not. Mayer also made additional changes to the offer letter that materially increased the size of de Castro's payout if he was terminated early without cause, by re-allocating value among the different types of awards that had different vesting acceleration terms upon termination without cause. These changes were not discussed with or approved by the Committee. Vice Chancellor Laster calculated that the changes increased the value of de Castro's payout during the first year by $21 million, or 263%, and during the second year by $11.25 million, or 94%.

de Castro was unsuccessful in his position and Mayer decided to terminate him without cause after about 14 months of employment. The Committee approved her decision through action by written consent dated January 12, 2014. The Committee did not meet in person or by phone before the decision, and the Court noted that "[t]here is no evidence that the Committee evaluated the alterative of a for-cause termination or was provided with a calculation of the severance benefits that de Castro would receive." When approved by the Committee, the anticipated value of the equity awards as a result of a termination without cause was $23.58 million; but due to an increase in Yahoo!'s stock price, the value of de Castro's awards at the time of his termination was nearly $60 million.

In the Opinion, Vice Chancellor Laster quips that this case "evokes the *Disney* case, with the details updated for a twenty-first century, New Economy company." He explains that, "[l]ike the current scenario, *Disney* involved a CEO hiring a number-two executive for munificent compensation, poor performance by the number-two executive, and a no-fault termination after approximately a year on the job that conferred dynastic wealth on the executive under circumstances where a for-cause termination could have been justified." The *Disney* case concluded, of course, with a pyrrhic victory for the director defendants who prevailed on the merits only after years of litigation and a 37-day trial on the merits.

Outcome of the Section 220 Action

As mentioned above, the Court was considering these facts in the context of a Section 220 action, rather than a derivative claim. The Court has encouraged potential plaintiffs to use Section 220 to obtain information about a corporation before initiating a derivative lawsuit. To obtain books and records under Section 220, a plaintiff must establish by a preponderance of the evidence that she possesses a proper purpose for seeking the information. Under Delaware law, investigating alleged Board-member mismanagement and the possible filing of a derivative claim are proper purposes only if the stockholder advances a "credible basis" to infer that such mismanagement occurred.

The credible basis standard "sets the lowest possible burden of proof." Thus, as the Court explains, "[a] showing that is sufficient to conduct an inspection 'may ultimately fall well short of demonstrating that anything wrong occurred.'" Nonetheless, Vice Chancellor Laster notes that where the stockholder can only make a meager showing of potential wrongdoing, it is possible that the Court may conclude that there was no credible basis to suspect the possibility of misconduct that would support a non-exculpated claim.

Based on the facts discussed above, Vice Chancellor Laster determined that there was a credible basis to suspect possible wrongdoing sufficient to warrant further investigation, and ordered the production of various documents requested by Amalgamated. Vice Chancellor Laster identified possible breaches in the hiring process as well as the firing process, and even found a credible basis to suspect corporate waste, despite the difficult standard for waste claims under Delaware law.

Tips on Best Practices

The *Yahoo!* case demonstrates the importance of process in helping a board to resist a Section 220 action or win on a motion to dismiss. The Opinion provides a guide to best practices that directors should consider when evaluating and approving executive compensation packages. Indeed, many of the points echo the advice given by Chief Justice Strine of the Delaware Supreme Court in his recent article titled "Documenting the Deal: How Quality Control and Candor Can Improve Boardroom Decision-making and Reduce the Litigation Target Zone."[2]

Explore potential conflicts: Both Mayer and de Castro worked at Google before she sought to hire him for Yahoo!. As part of its argument, "Amalgamated observes that just as Eisner was negotiating with his friend Ovitz in the *Disney* case, Mayer was negotiating with a colleague from her former employer." Vice Chancellor Laster concludes that once it became aware of this relationship, the Board should have considered whether it was appropriate for Mayer to continue to lead the negotiations, or whether someone else should take over. He notes that it is important that there be a record that the relationship was disclosed and vetted in a timely way to the Board. He suggests that the Committee should not only explore potential conflicts with directors and senior officers, but also with any compensation consultants used by the Committee.

[2] 70 Bus. Law. 679 (2015), and available here.

Create helpful Board materials: Vice Chancellor Laster noted multiple times that neither the Committee nor the Board had received any materials that illustrated: (i) how the different compensation components interacted, (ii) how much compensation would be paid in particular departure scenarios, (iii) the potential monetary effect of any change being considered or (iv) the way that changes affected the payouts associated with those previously analyzed departure scenarios. Directors should be provided with a summary of any agreement's key features, so they can understand the material terms. As the Opinion illustrates, it may be helpful to present that information in a chart or table format.

Give directors time to review the materials before the meeting: The Committee only considered the term sheet for 30 minutes, which Vice Chancellor Laster implied was not long enough for such a complex agreement. As Chief Justice Strine noted in his article, "when directors are not given key information in advance of meetings, they may not absorb it." Directors should be given important documents (including summaries) in advance of the meeting, so they have time to review and mark areas for follow up questions.

Run a redline: Vice Chancellor Laster noted that "[t]he Committee never received any calculations showing the value of the changes, much less the aggregate effect of all of the changes." As Chief Justice Strine has advised, the board should always be provided with a redline to the previous version it considered, so it can see the changes made to a negotiated document. Obviously, a redline highlights changes, helping focus directors' attention on the provisions that are of principal concern to the executive in the negotiations. A redline also helps to confirm the changes are correct. Had a redline been run, it is possible that someone may have noticed Mayer's error regarding the original duration of the tail period.

Directors should not be passive: Vice Chancellor Laster was critical of directors who seem to have "accepted Mayer's statements uncritically," did not ask questions during either the hiring or firing of de Castro and "rubberstamped what Mayer had done…" He cautions that "[a] board cannot mindlessly swallow information, particularly in the area of executive compensation" because "Directors who choose not to ask questions take the risk that they may have to provide explanations later." This echoes Chief Justice Strine's critique that:

> "Instead of pressing management for answers . . . directors sometimes act more like well-mannered season ticketholders to a stylized interactive theatre, in which performing managers shepherd the audience through ritualized plays, listen to management give set piece reports, ask a few brief questions so as not to disrupt the actors' timing, and complete a series of management-driven acts, often written not in the blunt, earthy style of an Arthur Miller, but in the opaque, high-falutin style of a jejune drama student in a Master of Fine Arts program."

Vice Chancellor Laster describes this "ostrich-like conduct" as "warranting further investigation."

Document the decision carefully in Board minutes: Vice Chancellor Laster states that there did not seem to be any evidence of discussion of the terms or questions about the executive compensation package reflected in the Board minutes. He noted that "[t]here is no evidence that anyone addressed the magnitude of the change" and "[t]here is no evidence

that anyone examined the definition of cause." Of course, it is possible that Yahoo!'s directors will offer credible testimony that these changes were discussed. However, it is more likely that a 220 demand will be granted, or a motion to dismiss will be denied, where the minutes are not adequate to document the Board's informed deliberations and sustain the Board's actions. As the Court noted in *Disney*, "a Board's failure to properly document their decisions risks the time and expense of a lengthy trial and opens the door to the possibility of a finding that the business judgment rule has not been satisfied."[3]

Conclusion

Compensation committee members and their advisors should be disciplined in their focus on good process in the context of negotiating and approving executive compensation arrangements. There are sometimes obstacles to maintaining that discipline, including time pressures and the sensitivity of personnel and compensation decisions. Surrendering to the obstacles entails legal risks.

If you have any questions, please feel free to contact any of your regular contacts at the firm or any of our partners and counsel listed under Corporate Governance, Executive Compensation and ERISA or Litigation and Arbitration under the "Practices" section of our website at http://www.clearygottlieb.com.

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[3] *In re Walt Disney Co. Deriv. Litig.*, 825 A.2d 275, 278 (Del. Ch. 2003).

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