Bloomberg BNA

Tax Management
Compensation Planning Journal™

Reproduced with permission from Tax Management Compensation Planning Journal, Vol. 45, 8, p. 207, 08/04/2017. Copyright © 2017 by The Bureau of National Affairs, Inc. (800-372-1033) http://www.bna.com

Recent Litigation Developments Affecting Delaware Executive Compensation

By Robert Rachal, Esq.[*]

OVERVIEW

An interesting mix of issues have been litigated recently under Delaware law related to executive compensation. One issue relates to what shareholders are required to ratify to provide business judgment protection to directors' decisions on their compensation. The *Citrix*[1] and *Investors Bancorp*[2] cases discussed below provide some helpful parameters, but there still may be some unresolved space between unprotected "blank checks" and valid, ratified director-specific limits. The *Advaxis*[3] case discussed below also suggests that a court may construe the scope of shareholder ratification narrowly on those decisions if it believes that the directors may have engaged in wrongdoing.

Another recent case analyzed whether directors failed meaningfully to exercise their business judgment in approving what appears to be excessive executive compensation. From the pleadings, *Yahoo!*[4] appears to be a repeat of *Disney*,[5] where a powerful CEO was given close to a blank check by the directors to hire a second-in-command, and the hire ended expensively and badly for the company. Note, though, that the *Disney* directors prevailed after trial, and the full facts in *Yahoo!* are currently unknown.

Another issue recently litigated includes whether directors are considered independent of controlling shareholders who appoint them when deciding those shareholders' executive compensation. *Cablevision*[6] suggests that there is a presumption of independence absent compelling facts showing that the controlling shareholders usurped that decision, or coerced the directors in the exercise of their judgment. The *Saba Software*[7] and *Zynga*[8] cases discussed below illustrate how equity compensation, in certain circumstances, can create potential conflicts with the interests of other shareholders. Like in *Yahoo!*, the decisions in *Saba Software* and *Zynga*, however, are based only on plaintiffs' allegations, and the facts in these cases are currently unknown.

Finally, in *Wal-Mart*,[9] the Delaware Supreme Court recently adopted the *Garner* corporate fiduciary exception to the attorney-client privilege. Based on how Delaware courts are applying this exception, if plaintiff can provide credible allegations of wrongdoing related to executive compensation, and privileged documents are essential to investigate this claim, there is a significant risk that this legal advice may not be privileged.

---

[*] Robert Rachal, Esq. is a member of Holifield, Janich, Rachal & Associates PLLC. Robert's work focuses on complex ERISA and executive compensation litigation. Robert advises and defends employers on claims by executives seeking benefits under SERP and bonus or "top hat" plans, and advises employers on ERISA fiduciary and benefit claim issues. Robert also routinely represents executives who have been sued as alleged ERISA fiduciaries for employee benefit plans, including §401(k) and ESOP plans.

[1] *Calma v. Templeton*, 114 A.3d 563, 577 (Del. Ch. 2015) (*Citrix*).

[2] *In re Investors Bancorp Stockholder Litig.*, No. 12327-VCS, 2017 BL 111738 (Del. Ch. Apr. 5, 2017).

[3] *Bono v. O'Connor*, No. 15-6326 (FLW)(DEA), 2016 BL 163723 (D.N.J. May 23, 2016) (*Advaxis*), *reconsideration denied*, No. 15-6326(FLW), 2016 BL 457964 (D.N.J. Oct. 05, 2016).

[4] *Amalgamated Bank v. Yahoo! Inc.*, 132 A.3d 752, 778 (Del. Ch. 2016).

[5] *In re Walt Disney Co. Derivative Litig.*, 825 A.2d 275, 286–290 (Del. Ch. 2003).

[6] *Friedman v. Dolan*, No. 9425-VCN, 2015 BL 209974 (Del. Ch. June 30, 2015) (*Cablevision*).

[7] *In re Saba Software, Inc. Shareholder Litig.*, No. 10697-VCS, 2017 BL 105912 (Del. Ch. Mar. 31, 2017).

[8] *Lee v. Pincus* (*Zynga*), No. 8458-CB, 2014 BL 322609 (Del. Ch. Nov. 14, 2014).

[9] *Wal-Mart Stores, Inc. v. Ind. Elec. Workers Pension Trust Fund IBEW*, 95 A.3d 1264 (Del. 2014).

© 2017 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0747-8607

RECENT ISSUES

Calma v. Templeton and Shareholder Ratification of Director Compensation

Because of a director's financial interest in his compensation, directors' decisions on this issue are, absent shareholder ratification, typically subject to an ''entire fairness'' standard — i.e., ''the directors must establish 'to the *court's* satisfaction that the transaction was the product of both fair dealing *and* fair price.''[10] With shareholder ratification, however, a court reviews the compensation decision under the business judgment rule only for waste.[11] The key threshold issue is whether shareholders have properly ratified director compensation, with ratification typically leading to dismissal on the pleadings, and non-ratification typically leading to burdensome litigation into the reasonableness of the directors' compensation. The *3Com*, *Citrix*, and *Investors Bancorp* cases discussed below illustrate how Delaware courts are analyzing this issue, with a focus on whether there was some shareholder approval specific to directors, such as by inclusion of director sub-limits in a ratified plan.

In re 3COM Shareholder Litigation.[12] Shareholders claimed directors breached their fiduciary duties of loyalty by awarding themselves excessive compensation in a stock option plan. The court (Vice Chancellor Steele) analyzed whether shareholders' approval of the plan made the directors' award of options to themselves subject to the business judgment rule.

In 1998, the directors awarded themselves between 22,500 to 45,000 options each (out of a pool of 167,000 shares) under the shareholder-approved plan. The court held that plan had sufficiently defined terms to make that approval effective: the plan included director-specific ceilings, and the challenged awards were within these parameters.

Calma v. Templeton (Citrix).[13] Breach of fiduciary duty claim relating to director equity awards survives motion to dismiss. The court (Chancellor Bouchard) held the business judgment rule was inapplicable; instead, the award was subject to review under the ''entire fairness'' standard.

The key issue for the court was that although the shareholders had approved the equity plan, that plan did not include director-specific limits: Shareholder approval of a plan with overall generic limits of 1 million shares (market value of $55 million) was not approval of awards to directors. Applying Delaware law, the court noted that approval of a plan without director-specific limits would give directors a ''blank check'' to act under the broad parameters of the plan.[14] The court distinguished *3COM* as having director-specific limits, and held that without these limits shareholders had not taken any action specific to approve or ratify director compensation.

Because the court concluded that there was no shareholder ratification, it applied the entire fairness standard to determine whether plaintiffs stated a claim of fiduciary breach. Total director compensation was in the $300,000 to $400,000 annual range during the challenged period, and appeared in line with the peer group identified by the company in its SEC filings. The court nonetheless concluded that plaintiffs stated a claim since it could not resolve on a motion to dismiss what was an appropriate company peer group for comparison.

In re Investors Bancorp Stockholder Litig.[15] The board submitted and the shareholders approved the 2015 Equity Incentive Plan, which for non-employee directors had a sublimit of 30% of all restricted stock (approximately 3.9 million shares) or options (approximately 5.3 million shares) offered in the plan. The average non-employee, director compensation for peer companies was around $157,000. After the shareholders approved the 2015 EIP, the non-employee directors awarded themselves $2,034,000 each under the plan.

The court (Vice Chancellor Slights) held that shareholder ratification of the 2015 EIP constituted ratification of these awards — thus, the business judgment rule applied, and the awards could be attacked only for waste. The court reasoned that the director-specific limits in the 2015 EIP were sufficient, and distinguished *Citrix* as a plan containing only generic limits. The court further noted that the awards did not need to be self-executing, nor do director-specific limits have to be ''meaningful limits'' to be effective. Although the court noted that the awards appeared to be quite large (more than 10 times larger than the peer group), it declined to try to police a ''meaningful limits'' line. Instead, the court reasoned that the doctrine of waste would provide residual protection for shareholders.

Investors Bancorp can provide helpful guidance post-*Citrix*. This approach squarely focuses shareholder ratification on form, whether a director sublimit was included, not on economic substance. Thus, director awards of $300,000 to $400,000 are challengeable in *Citrix*, even though they appeared to be in line with peer companies, but director awards of over

[10] *Calma*, 114 A.3d at 577.

[11] *Id.*

[12] C.A. No. 5067-CC (Del. Ch. Dec. 18, 2009).

[13] 114 A.3d 563 (Del. Ch. 2015).

[14] *Id.* at 583–584.

[15] No. 12327-VCS, 2017 BL 111738 (Del. Ch. Apr. 5, 2017).

© 2017 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0747-8607

$2 million are not challengeable in *Investors Bancorp*, even those these awards were more than 10 times larger than the peer group, and even though the director sub-limits were quite large — 3.9 million restricted stock units and 5.3 million stock options could be awarded in any calendar year to the director group. The ''no blank check'' reasoning in *Citrix* suggests that there may be some limits to how large these sub-limits can become, however; but whether and what those limits are may have to be fleshed out in further litigation. This focus on form over substance is also doctrinally consistent with *Espinoza v. Zuckerberg*,[16] where plaintiffs' challenge to director compensation of Facebook's outside, non-management directors was allowed to proceed even though the controlling shareholder, Mark Zuckerberg, had stated in deposition and affidavit that he approved this compensation. The court (Chancellor Bouchard) nonetheless held that this ratification was ineffective because it did not follow corporate forms, including proper notice to the other shareholders.

Bono v. O'Connor (Advaxis).[17] This case indicates, however, that courts may construe the scope of shareholder ratification narrowly if they are concerned over potential misconduct. Advaxis is a publicly held Delaware corporation. The board adopted a new equity compensation plan on March 30, 2015, and immediately awarded stock to director and officers subject to subsequent shareholder ratification of the plan. Plaintiff claimed this was a drastic break from past practice: among other things, the directors had already received their compensation for 2015 under the prior plan. In addition, the directors had no stock left under the prior plan, so to make the awards on March 30, 2015, they had to make the awards contingent on later shareholder approval. In April 2015, Advaxis made several disclosures that increased its stock price over 75% and resulted in paper profits to defendants from those awards of $15.8 million.

Plaintiff shareholder brought a derivative action claiming directors breached their fiduciary duties by spring-loading their equity compensation awards. Applying Delaware law, the court (U.S.D.J. Wolfson) held that the plaintiff stated a breach of fiduciary duty claim against the director committee defendants who both approved and benefitted from the option award. On defendants' ratification defense, the court held that subsequent shareholder approval of the plan was not approval of the awards disclosed in that plan: the shareholders were asked to approve the plan, not *specifically asked* to approve those awards.[18] The court also held that the awards were not pursuant to specific limits in the plan if they were spring-loaded, i.e., if the directors knew they were undervalued in light of pending disclosures. In contrast, the court held that there were no claims against the recipient — only director defendants because there was no basis to infer that they engaged in wrongdoing: they did not decide the timing or manner of the awards that created the suspicion of wrongdoing.

Yahoo and Alleged Excessive Pay — *Disney* Revisited?

Quoting Mark Twain, in *Amalgamated Bank v. Yahoo! Inc.*,[19] the court (Vice Chancellor Laster) noted that ''history may not repeat itself, but it often rhymes.'' The history referred to was the *Disney* case, and the saga therein about whether Disney's directors had breached their fiduciary duties to act in good faith and on an informed basis regarding the hiring and termination of Disney's second-in-command, Michael Ovitz.[20] As the *Yahoo!* court also noted, Disney's full import is complicated, however, as the directors ultimately prevailed after trial.[21]

In *Yahoo!*, a trustee on behalf of mutual funds filed a §220[22] action seeking to investigate the board's involvement in the hiring and subsequent firing of Yahoo's second-in-command, the Chief Operating Officer, Henrique de Castro. Mr. de Castro's compensation package (which included various options and restricted stock awards) was $39 million for the first year, and his severance grew from the originally approved $8 million to an expected $29 million if he was terminated without cause, even if terminated shortly after he was hired. Mr. de Castro performed poorly and was fired within a year; because of an increase in Yahoo's stock price from unrelated events (Yahoo's investment in Alibaba stock), he received $60 million in severance benefits.

The trustee Amalgamated Bank sought inspection of Yahoo's books and records. The court held that the trustee was entitled to do so because it had alleged a credible basis to infer fiduciary breach or waste (note that there has been no fact finding yet), including that:

- Mr. de Castro was offered a complex compensation package, yet the board appeared to have no

---

[16] 124 A.3d 47 (Del. Ch. 2015).

[17] No. 15-6326 (FLW) (DEA), 2016 BL 163723 (D.N.J. May 23, 2016), *reconsideration denied*, No. 15-6326 (FLW), 2016 BL 457964 (D.N.J. Oct. 5, 2016).

[18] Parallel litigation was also going on in Delaware chancery court before Chancellor Bouchard, and Judge Wolfson followed his analysis on this issue.

[19] 132 A.3d 752, 778 (Del. Ch. 2016).

[20] *See In re Walt Disney Co. Derivative Litig.*, 825 A.2d 275, 286–290 (Del. Ch. 2003).

[21] *See Yahoo!*, 132 A.3d at 779–780.

[22] 8 Del. C. §220.

© 2017 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0747-8607

tables or reports for calculating the financial impact and interrelationship of various provisions.

- It appeared that the CEO Marissa Mayer had not shared critical information on or acquired board approval on changes that materially increased the compensation offered to Mr. de Castro.
- It was not clear that the board exercised its independent business judgment in approving the package, and instead accepted Ms. Mayer's statements uncritically.
- Although it appears to be a $50 million plus issue, it does not appear that the board considered a for-cause termination, even though there may have been grounds to terminate Mr. de Castro for cause because of poor performance.

Similar to *Disney*, the *Yahoo!* case offers some thoughts on sound best practices that can help limit litigation exposure. One is for the board to explore potential conflicts — Ms. Mayer and Mr. de Castro both worked together at Google, and, at least at the allegation stage, Ms. Mayer appeared often to act unilaterally in increasing the compensation offered Mr. de Castro. Another is to create helpful board materials — e.g., complex compensation packages may require tables and the like to understand how the various components work together. The *Yahoo!* court called particular attention to this issue, noting that it had to create its own tables to understand and show (1) how Mr. de Castro's various compensation items worked together, and (2) the magnitude of the changes that Ms. Mayer made increasing Mr. de Castro's compensation. Likewise, the directors should have sufficient time to review these materials before the meeting, and any proposed changes to the offer should be highlighted. The directors should ask questions, as it ultimately needs to be their business judgment (not just the CEO's) on what to offer. Finally, the decision should be carefully documented in the board minutes.

Controlled Corporations and Director Independence on Compensation

Friedman v. Dolan (Cablevision).[23] This case addressed the application of the business judgment rule to executive compensation in a controlled corporation. Plaintiffs claimed that Cablevision's directors agreed to pay Executive Chairman (the founder, Charles Dolan) and the CEO (the son of the founder, James Dolan) excessive compensation. The Dolan family controls 75% of Cablevision's voting power.

Although the court (Vice Chancellor Noble) noted that it was troubled by the allegations, it also noted that the company was listed as a controlled company under NYSE rules, and refused to adopt a rule that would require courts to second-guess directors' business judgment regarding compensation for controlling shareholders. Rather, the independent compensation committee insulates from the claim that the controlling person was on both sides of transaction, absent proof that the controlling person compromised the directors' independence, or that the directors acted in bad faith. Reviewing the allegations, the court found that the compensation directors' independence was not compromised:

- Long-term board service, and appointment and self-nomination with the controller's approval were insufficient.
- Retirement and older age were insufficient.
- Refusing to follow non-controlling shareholders' direction was insufficient.
- A sibling's employment at a Dolan-controlled company was insufficient.

The court concluded that these allegations made no "reasonably conceivable case that the directors wanted to remain on the board so much that they sacrificed their professional integrity."[24] The court also found that there were no credible allegations of bad faith. The directors were not unreasonable in relying on the selected peer-group sample, and the Dolans were not prohibited from providing input to the directors, who were advised by a compensation consultant, to consider. The court also found that there were no allegations showing that the Dolans coerced the directors regarding the Dolans' compensation.

Executive and Equity Compensation Creating Alleged Motives to Act Against Shareholder Interests

Executive and equity compensation is, at least in theory, supposed to incentivize directors and officers to act in the interests of shareholders. In several recent cases, however, courts have analyzed whether the compensation and equity packages to directors and officers may have incentivized them to act contrary to those shareholder interests:

In re Saba Software, Inc. Shareholder Litigation.[25] The SEC deregistered the company after it repeatedly failing to correct its financial statements for fraud. The company merged in a deal that plaintiff shareholders claimed was too low and forced on them

[23] No. 9425-VCN, 2015 BL 209974 (Del. Ch. June 30, 2015).

[24] *Id.* at *7.

[25] No. 10697-VCS, 2017 BL 105912 (Del. Ch. Mar. 31, 2017).

© 2017 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0747-8607

because of deregistering of their stock. During this period, other bidders were appearing, but dropped out because the company was unable to complete its financial restatements in time to avoid deregistration.

The court (Vice Chancellor Slights) concluded that plaintiffs' allegations were sufficient to show that the shareholder vote approving this merger was coerced and not fully informed. The court also found that plaintiffs pled, among other things, an actionable breach of the duty of loyalty against the directors based on compensation payments that were tied to the merger. Specifically, the merger allowed the board to turn their illiquid equity awards into cash, versus keeping Saba as a stand-alone company, which may have been in the interests of the shareholders. The court noted that the looming deregistration neutralized these equity awards, while the merger was the only means to revive them and turn them into cash.

Lee v. Pincus (Zynga).[26] Plaintiffs brought breach of fiduciary duty claims of self-dealing regarding lock-up waivers. In the IPO for Zynga, most pre-IPO investors were subject to lock-up restrictions. The board restructured these lock-ups to allow staggered sales. Under this restructuring, half the members of the board, including the company founder, were allowed to sell a portion of their shares before others in a secondary offering. The founder received over $192 million in this early sale; other directors received between $3 million to $8 million. By selling early, these sellers were able to sell their Zynga stock at twice the price ($12 versus $6.09) of the stock at the expiration of the original lock-up period.

Plaintiff (a former employee) brought breach of fiduciary duty claims against the directors of Zynga for waiving post-IPO lock-up restrictions for certain stockholders. The court (Chancellor Bouchard) first held this was a direct not derivative claim because the harm was not to the company or shareholders generally, but to the pre-IPO shareholders subject to the lockout while others sold. The court then held that no contractual provision preempted the directors' fiduciary duties to the shareholders. The directors' actions modifying their shareholder rights were not pursuant to the terms of the plaintiffs' contracts, and plaintiffs alleged that they received an improper personal benefit contrary to their duty of loyalty to plaintiff and the other shareholders that remained subject to the lock-up restrictions. The court held that plaintiffs' fiduciary breach claim survived a motion to dismiss because the business judgment standard was rebutted in light of that half of the directors were not disinterested. At the time of the decision, the benefit to the affected directors of selling some shares early may have outweighed any potential detriment on extending the lock-up period on their other shares.

Other Compensation Issues

Failure to Comply With §162(m) for Tax Deductions

Freedman v. Adams.[27] From 2004–2007, XTO Energy paid more than $130 million in executive bonuses. The board decided not to seek to make XTO's compensation plan tax deductible under I.R.C. §162(m) because it did not want to be constrained by that criteria in paying bonuses.

A plaintiff shareholder brought suit alleging that XTO's decision to not seek tax-deductible status constituted corporate waste, because XTO paid an additional approximately $40 million in taxes because of this. The court rejected the claim, stating that ''[t]he decision to sacrifice some tax savings in order to retain flexibility in compensation decisions is a classic exercise of business judgment.''[28] *Freedman* thus clearly confirms a board's ability under the business judgment rule to make compensation decisions that, in the board's view, best fit the corporation's needs, even if it means forgoing tax benefits.

Say-on-Pay Vote

Raul v. Rynd.[29] In 2010, the board of Hercules Offshore approved a new executive compensation plan that raised executive compensation by between 40% and 190%. Pursuant to §951 of the Dodd-Frank Wall Street Reform and Consumer Protection Act,[30] Hercules held a say-on-pay vote at its annual meeting, where shareholders rejected the executive compensation package, with 59% voting against the package. Hercules implemented the compensation plan despite the shareholder vote.

Plaintiff shareholder brought a derivative suit claiming, in part, that Hercules breached its fiduciary duty by going forward with the executive compensation plan despite the adverse shareholder vote. The district court explained that plaintiff's claims were ''flawed'' because the Dodd-Frank Act explicitly states that say-on-pay votes are not binding and do not '' 'create or imply any change to the fiduciary duties of a company' or its board of directors.''[31] The court dismissed plaintiff's claims for failure to make a presuit demand on the board because he failed to demonstrate that the board would have been unable objec-

[26] No. 8458-CB, 2014 BL 322609 (Del. Ch. Nov. 14, 2014).

[27] 58 A.3d 414 (Del. 2013).

[28] *Id.* at 417.

[29] 929 F. Supp. 2d 333 (D. Del. 2013).

[30] Pub. L. No. 111-203.

[31] *Raul*, 929 F. Supp. 2d at 344.

© 2017 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0747-8607

tively to evaluate the demand — under Dodd-Frank the shareholder vote did not give rise to a substantial claim of personal liability. *Raul* confirms that say-on-pay votes required by Dodd-Frank are not binding, and are not good grounds in themselves to sue over executive compensation decisions.

LIMITATIONS ON PRIVILEGE POTENTIALLY AFFECTING EXECUTIVE COMPENSATION

Legal advice related to executive compensation may not always be privileged.

ERISA Fiduciary Exception

ERISA has a fiduciary exception to the attorney client privilege that means if the actor is acting in an ERISA fiduciary capacity regarding employee benefits, legal advice related to that work may not be privileged. This exception is based principally on the notion that the fiduciaries are obligated to act on behalf of the beneficiaries, who are the real clients regarding this legal advice.[32]

Regarding executive compensation, severance benefits and deferred compensation plans may be ERISA benefits subject to ERISA fiduciary duties; with key exceptions excluding from these duties (1) excess benefit plans (unfunded, providing benefits in excess of I.R.C. §415 limits) and (2) ''top hat'' plans (unfunded, providing deferred compensation for a select group of management or highly compensated employees).[33] If applicable, ERISA fiduciary duties relate to plan management and administration, such as communicating on benefits and deciding claims for benefits, but not settlor functions deciding the design and terms of the plan.[34] Advice that a fiduciary receives to protect himself from personal liability also is not subject to this fiduciary exception.[35]

[32] *See, e.g., United States v. Mett*, 178 F.3d 1058, 1064 (9th Cir. 1999).

[33] Companies may still be subject to duties of good faith and fair dealing regarding their administration and exercise of discretion under these excluded plans. *See, e.g., Niebauer v. Crane & Co., Inc.*, 783 F.3d 914, 923 (1st Cir. 2015) (applying same to top-hat plan). *See also* ERISA §3(36), ERISA §401(a)(1).

[34] *See, e.g., In re Long Island Lighting Co.*, 129 F.3d 268 (2d Cir. 1997).

[35] *See, e.g., Tatum v. R.J. Reynolds Tobacco Co.*, 247 F.R.D. 488 (M.D.N.C. 2008) (concluding that fiduciary exception was inapplicable to communications relating to imminent lawsuit and fiduciaries' concern for their own liability).

Corporate Fiduciary Exception

There also can be a *corporate* fiduciary exception that can apply to defeat privilege, which arises out of the seminal case of *Garner v. Wolfinbarger*.[36] Although this exception has potentially broader application than the ERISA exception, *Garner* imposes a ''good cause'' requirement on the party seeking documents.

Of import to Delaware corporations, in *Wal-Mart Stores v. Ind. Elec. Workers Pension Trust Fund IBEW*,[37] the Delaware Supreme Court recently explicitly adopted the *Garner* exception, including applying it to a §220 proceeding on a shareholder union's request for Wal-Mart's corporate books and records related to the alleged bribery of Mexican officials. *Wal-Mart* also illustrates the applicability of the ''good cause'' requirement, concluding that the union had met these standards:

- The union had demonstrated a colorable claim of wrongdoing (this had been the subject of a front-page investigative report in the *New York Times*).
- The information regarding how Wal-Mart investigated these bribery allegations was available from other sources.
- The information request was particularized, and predated and did not concern the present litigation.
- *Garner's* other ''good cause'' factors supported disclosure: (1) disclosure would not reveal trade secrets; (2) the allegations implicate criminal conduct under the Foreign Corrupt Practices Act; and (3) the union is a legitimate shareholder of Wal-Mart.

The *Garner* factors, and the way that *Wal-Mart* adopted and applied them, suggest that the *Garner* exception may be broadly applied. The factors appear skewed to favor annulment of the privilege when high stakes legal advice is involved over contentious issues; many would argue that this is precisely *when* the privilege is most needed.

An example of this is *In re Lululemon Athletica Inc. 220 Litig.*[38] *Lululemon* involved the claim that the founder and board chairperson sold shares based on inside information that Lululemon's CEO was resigning. The *Wall Street Journal* inquired about these trades, and the company's corporate counsel, officers, and directors exchanged emails to develop a coordinated response. The court (Vice Chancellor Parsons)

[36] 430 F.3d 1093 (5th Cir. 1970).

[37] 95 A.3d 1264 (Del. 2014).

[38] No. 9039-VCP, 2015 BL 126240 (Del. Ch. Apr. 30, 2015).

© 2017 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0747-8607

determined that some of these emails were privileged, but that the *Garner/Wal-Mart* fiduciary exception to the privilege applied. The court found that (1) the stockholder's mismanagement and insider-trading claims were colorable, (2) the sought-after information was necessary for the investigation and likely unavailable elsewhere, (3) the purpose behind seeking the privileged information was proper, and (4) the legal advice in the emails was more like ''real-time'' evidence than preparatory plans for litigation. In light of this, the court held that the plaintiffs demonstrated good cause and were entitled to review the emails under *Garner*'s fiduciary exception to privilege.

In contrast, in *Amalgamated Bank v. Yahoo! Inc.*,[39] the court (Vice Chancellor Laster) found the *Garner* analysis premature. As noted above, *Yahoo!* involved a §220 investigation into whether the board breached its fiduciary duties related to the compensation offered Yahoo's COO. The court found that prior to undertaking a *Garner* analysis, it must first determine that the privileged documents are essential, because that inquiry is dispositive of the threshold question — the scope of document production to which the party is statutorily entitled. The court held that the threshold question of essentiality could not be determined until, in responding on documents that the court has identified as essential, defendant identifies and logs any documents that are privileged.

In sum, it appears that Delaware courts are reading the *Garner/Wal-Mart* exception expansively if plaintiff can provide credible allegations of wrongdoing, and these privileged documents are essential to investigate this claim. Because of this uncertainty and potential broad application of *Garner/Wal-Mart*, counsel advising the corporation will need to consider that sometimes their advice effectively may not be privileged and confidential. And because of this uncertainty, corporate officers at legal risk may need to consider engaging their own counsel to be able to receive candid privileged advice in fraught situations.

CONCLUDING THOUGHTS

Courts in Delaware continue to give broad deference to directors' exercise of their business judgment regarding executive compensation, relying on the capital markets — not judges — to police the soundness of those business decisions. Thus in *Cablevision*, although the court noted that it was troubled by the allegations, it also noted that the company was listed as a controlled company under NYSE rules, and refused to second-guess the directors' business judgment regarding the controlling shareholders compensation. However, if plaintiffs can credibly allege that directors abdicated their duties (*Yahoo!*) or engaged in misconduct and self-dealing (*Advaxis, Saba Software*), the courts will undertake a fulsome review of those decisions.

Delaware's adoption of the *Garner* corporate fiduciary exception adds another layer of complexity to advising boards in this area. If plaintiff can provide credible allegations of wrongdoing related to executive compensation, and privileged documents are essential to investigate this claim, this exception creates a significant risk that this legal advice may not be privileged.

[39] 132 A.3d 752 (Del. Ch. 2016).

© 2017 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0747-8607