Hot Issues in Executive Compensation 2018

Ethical Considerations When Counseling Boards, Compensation Committees, Companies and Executives

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Agenda

- Who is the client and related dilemmas
- Adviser independence
- Privilege
- Delaware law developments

WHO IS THE CLIENT AND RELATED DILEMMAS

Who is the Client?

- Identify the client
  - Sounds simple, but often it is not
  - Critical to understand from the outset who you represent
    - Engagement letters
  - Within an organization, people wear many hats
    - E.g., officer, director, individual

Who is the Client? (cont'd)

- Model Rule 1.13: Organization as Client

  (a): A lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents.

  (f): In dealing with an organization's directors, officers, employees, members, shareholders or other constituents, a lawyer shall explain the identity of the client when the lawyer knows or reasonably should know that the organization's interests are adverse to those of the constituents with whom the lawyer is dealing.

  (g): A lawyer representing an organization may also represent any of its directors, officers, employees, members, shareholders or other constituents, subject to the provisions of Rule 1.7. If the organization's consent to the dual representation is required by Rule 1.7, the consent shall be given by an appropriate official of the organization other than the individual who is to be represented, or by the shareholders.

Who is the Client? (cont'd)

- Who are "constituents"?
  - Corporate officers
  - Employees
  - Shareholders
  - Directors
  - Trustees

Who is the Client? (cont'd)

- Keeping the Parties Informed
  - Make sure that the parties know who you represent and who you do not represent
  - Affirmative obligations to clarify misconceptions and misunderstandings
  - Model Rule 4.3
    - In dealing on behalf of a client with a person who is not represented by counsel, a lawyer shall not state or imply that the lawyer is disinterested. When the lawyer knows or reasonably should know that the unrepresented person misunderstands the lawyer's role in the matter, the lawyer shall make reasonable efforts to correct the misunderstanding.
    - The lawyer shall not give legal advice to an unrepresented person, other than the advice to secure counsel, if the lawyer knows or reasonably should know that the interests of such a person are or have a reasonable possibility of being in conflict with the interests of the client.

Who is the Client? (cont'd)

- Internal Investigations
  - Interest of company and other constituents are often opposed in connection with internal investigations.
  - U.S. v. William Ruehle (9th Circ. 2009) – Broadcom's audit committee engaged a law firm with longstanding ties to the company to conduct an internal investigation on possible stock option back dating issues. Defendant Ruehle (the company's CFO) participated in many discussions with the law firm on the issue. Later, when Ruehle was indicted on related criminal charges, he argued that he had an attorney-client relationship with the law firm. He also claimed to receive no warning containing notice that the law firm acted for the audit committee (although this was disputed by the law firm).
    - District court found, among other things, that Ruehle reasonably believed that the law firm was representing him personally. The court referred the law firm to the California State Bar for possible discipline for violating rules of professional conduct.
    - Decision was overruled by the 9th Circuit based on other grounds, but the case is a good illustration of the dangers of being unclear to constituents as to the identity of the client when engaged by a board committee for an internal investigation.

Representation of Multiple Parties/Conflicts

- Can you represent multiple constituents?
  - Maybe
- Model Rule 1.7

  (a) Except as provided in paragraph (b), a lawyer shall not represent a client if the representation involves a concurrent conflict of interest. A concurrent conflict of interest exists if:

  (1) the representation of one client will be directly adverse to another client; or

  (2) there is significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client, a former client or a third person by a personal interest of the lawyer.

Representation of Multiple Parties/Conflicts (cont'd)

- Model Rule 1.7 (cont'd)

  (b) Notwithstanding the existence of a concurrent conflict of interest under paragraph (a), a lawyer may represent a client if:

  (1) the lawyer reasonably believes that the lawyer will be able to provide a competent and diligent representation to each affected client;

  (2) the representation is not prohibited by law;

  (3) the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal; and

  (4) each affected client gives informed consent, confirmed in writing.

Special Considerations for Executive Compensation and Public Companies

- Functioning in an environment where any and all actions will be second guessed
- Face risk of:
  - Liability
  - Shareholder backlash
  - Negative publicity
- Liability – fiduciary duties
  - Duty of care
  - Duty of loyalty
  - Business Judgment Rule

ADVISER INDEPENDENCE

Adviser Independence – Impact of Dodd-Frank

- Compensation Committee and Independent Advisers
  - Background on key rules
    - Section 952(b) of the Dodd-Frank Act added new Section 10C to the Securities Exchange Act of 1934
    - SEC adopted Rule 10C-1 to the Exchange Act Rules directing the national securities exchanges to adopt listing standards regarding adviser independence for compensation committees
    - Under the listing standards adopted by NYSE and Nasdaq adviser independence assessment compliance became effective July 1, 2013

Adviser Independence – Impact of Dodd-Frank (Cont'd)

- Compensation Committee and Independent Advisers
  - When is advice "advice"?
    - Consideration of the independence of an adviser should take place prior to the Compensation Committee's receipt of advice
  - Compensation Committee may only select a compensation consultant, legal counsel or other adviser to the committee after considering certain factors, that include:
    - other services provided to the Company by the entity employing the independent adviser;
    - amount of fees received from the Company by the entity that employs the independent adviser, as a percentage of total revenue of that entity;
    - policies and procedures of the entity that employs the independent adviser that are designed to prevent conflicts of interest;
    - any business or personal relationships of the independent adviser with a member of the Compensation Committee;
    - any Company stock owned by the independent adviser; and
    - any business or personal relationships of the independent adviser or the adviser's firm with an executive officer of the Company

Adviser Independence – Impact of Dodd-Frank (Cont'd)

- Rules give Compensation Committee the authority:
  - in its sole discretion, to retain and obtain the advice of compensation advisers;
  - obtain appropriate funding from the Company, as the Compensation Committee determines, for payment of reasonable compensation to a compensation consultant, independent legal counsel or other adviser; and
  - to be directly responsible for the independent adviser's appointment, compensation and oversight of work performed by the adviser
- What is NOT required?
  - Independent adviser rules do not require that a Compensation Committee obtain advice solely from an "independent" adviser
  - Nor is the Committee required to follow the advice or recommendations of the adviser

Adviser Independence – Impact of Dodd-Frank (Cont'd)

- Implementation/Review Process
  - Are guidelines in place for the selection of independent advisers (as, and if, needed) as part of the Compensation Committee's overall governance framework?
  - Is an independent adviser really what's needed?
  - Certain circumstances that may factor into the decision-making process of whether to retain an independent adviser may include:
    - key special projects (e.g., new senior-level hires); and
    - situations where there is a clear need for independence (e.g., conflict situations)

Adviser Independence – Impact of Dodd-Frank (Cont'd)

- Disclosure requirement imposed under the Dodd-Frank commenced with proxy statements for annual meeting occurring on or after July 16, 2011 of:
  - the Compensation Committee's decisions with respect to the independent compensation consultant as to whether:
    - the committee retained or obtained advice of an independent compensation consultant;
    - such consultant's services raised any conflict-of-interest concerns; and if, so,
    - the nature of the conflict and how addressed

Adviser Independence – Who is the Client?

- When being retained by the Committee, an adviser should be clear on the question of who is the client
  - Again, sounds simple, but may not be on its face
  - Is the client:
    - the entire Compensation Committee;
    - the Chair of the Compensation Committee;
    - the entire Board of Directors;
    - Individual committee members;
    - the Company; or maybe
    - senior management??? (we can easily rule this one out)

Other Considerations for Public Companies

- The Sarbanes-Oxley Act of 2002 (“SOX”) (in some ways a precursor to Dodd-Frank) grants authority to an Audit Committee to retain independent advisers
- Section 301 of SOX (added Section 10A(m) to the Exchange Act) provides an audit committee authority to engage advisers, as it deems necessary to carry out its duties
  - There is no affirmative obligation imposed under SOX 301 that an Audit Committee retain independent advisers
- Section 307 of SOX applies “standards of professional conduct for attorneys appearing and practicing before the [SEC] in any way in the representation of issuers”
  - Certain standards under the rules “supplement” applicable state ethics standards unless the state rules are more “rigorous”
  - Be mindful that “practicing before the SEC” is defined broadly

Other Considerations for Public Companies – "Up the Ladder" Reporting under SOX

- Obligation for an attorney to report "up the ladder" to the chief legal counsel or CEO (or equivalent) of the Company, any evidence of:
  - a material violation of securities law;
  - breach of fiduciary duty;
  - or similar violation, in each case, by the Company or any of its agents
- If there is no appropriate response in the first instance, the attorney is further required to report up to:
  - the Audit Committee;
  - other Board committee comprised solely of directors not employed (directly or indirectly) by the Company; or
  - the Board

Other Considerations for Public Companies – "Up the Ladder" Reporting under ABA Model Rules

- Similar reporting obligations under the ABA Model Rules
- ABA Model Rule 1.13(b) and (c) Organization As Client -- If a lawyer for an organization knows that an officer, employee or other person associated with the organization is engaged in action, intends to act or refuses to act in a matter related to the representation that is a violation of a legal obligation to the organization, or a violation of law that reasonably might be imputed to the organization, and that is likely to result in substantial injury to the organization, then the lawyer shall proceed as is reasonably necessary in the best interest of the organization…
- The Model Rule also provides for 'up the ladder," including, if warranted to the highest authority that can act on behalf of the organization.
- Or in the case of failure of such authority to act, and the lawyer reasonably believes that the violation is reasonably certain to result in substantial injury to the organization, the lawyer may reveal the information outside of the organization (whether or not Rule 1.6 permits such disclosure).

ATTORNEY-CLIENT PRIVILEGE ISSUES AND CONCERNS

Attorney-Client Privilege and Some Pertinent Key Exceptions

- Corporate legal advice related to executive compensation may not always be privileged.
- ERISA fiduciary exception
  - If acting in an ERISA fiduciary capacity, the communication effectively is often not privileged.
  - When are you acting in an ERISA fiduciary capacity?
  - What is the scope and limit of the privilege in that capacity?
- *Garner* corporate fiduciary exception
  - What is the scope and limit of the privilege in that corporate fiduciary capacity?
  - Although of potentially broader application, *Garner* imposes a “good cause” requirement on the party seeking documents.

A Quick Note on Work Product Doctrine

- Codified in Rule 26(b)(3):
- (A) Documents and Tangible Things
  - prepared in anticipation of litigation or for trial by or for another party or its representative
  - can only be discovered if: otherwise discoverable and substantial need and cannot obtain by other means
- (B) Protection Against Disclosure
  - If court orders discovery of those materials, it must protect against disclosure of mental impressions, conclusions, opinions, or legal theories concerning the litigation.
- If legal work is in anticipation or defense of litigation, this may provide an alternative way to protect legal communications and advice. *But see Wal-Mart v IBEW* discussed later.

ERISA Fiduciary Versus Settlor Issues

- ERISA fiduciary exception: key threshold question, is the client acting as an ERISA fiduciary?
- Settlor – corporate business decisions, such as whether to merge or spin-off plans
  - Company can act in its own interests in making these decisions. *E.g., Malia v. General Electric Co*., 23 F.3d 828, 833 (3d Cir. 1994); *Flannigan v. General Electric Co.*, 242 F.3d 78, 87-88 (2d Cir. 2001) (claim using pension surplus to get higher sales price)
- Fiduciary – ERISA plan management and administration. Includes communication on plan benefits, and management of the plan's assets.
  - Sometimes benefits for executives are **not** subject to ERISA fiduciary duties, *e.g.*, top hat plans, most bonus plans.

Rationale Behind the ERISA Fiduciary Exception

- Duty to Disclose
  - Fiduciary exception derives from an ERISA fiduciary's duty to disclose
  - Plan beneficiaries are entitled to all information regarding plan administration
  - The attorney-client privilege gives way to this competing legal principle
- The "Real Client"
  - As a representative for the beneficiaries of the plan which she/he is administering, the beneficiaries, and not the fiduciaries, are the real clients
  - The fiduciary exception is not an "exception" to the attorney-client privilege; the fiduciary never enjoyed the privilege in the first place
- *U.S. v. Jicarilla Apache Nation*, 131 S. Ct. 2311 (2011)
  - Non-ERISA case. Neither party disputed the existence of a common law fiduciary exception and the Court assumed such an exception exists

Limitations to the ERISA Fiduciary Exception

- Courts have recognized that there are circumstances where the ERISA fiduciary exception is inapplicable.
  - Where the advice relates to a settlor function
  - Where the goal of the advice is to advise the fiduciary of his or her potential personal liability
  - Divergent interests/anticipation of litigation:
    - Where the advice pertains to matters involving a participant who is adverse to the plan (in anticipation of litigation).
    - Where attorney work product is prepared for the plan in anticipation of litigation, such that plan's interests diverge from the participant's

GARNER CORPORATE FIDUCIARY EXCEPTION

The Corporate Fiduciary Exception's Modern Genesis in *Garner v. Wolfinbarger*

- ERISA fiduciary exception and the modern corporate fiduciary exception grew out of an action brought by shareholders in *Garner v. Wolfinbarger*, 430 F.3d 1093 (5th Cir. 1970).
  - The Garner court looked at older English cases that analogized the corporate-shareholder to the trustee-beneficiary relationship to conclude the privilege was not absolute against the shareholders.
  - The *Garner* court also rested its decision on the fact that "joint clients" cannot assert the privilege against each other.
  - The *Garner* court however imposed a "good cause" standard that the shareholders had to satisfy to have access to the privileged communications.

Delaware Court's Adoption of *Garner in Walmart*

- *Wal-Mart Stores v. Indiana Electrical Workers Pension Trust Fund, IBE*W, 95 A. 3d 1264 (Del., 2014).
- Section 220 proceeding on IBEW's requests for Wal-Mart's corporate books and records related to the alleged bribery of Mexican officials.
- Court held *Garner* can be applied in both plenary proceedings and section 220 actions for corporate books and records.

"Good Cause" Limitations and *Walmart*

- *Wal-Mart* also illustrates the applicability of the "good cause" requirement:
  - Whether IBEW had demonstrated a colorable claim of wrongdoing.
  - Whether the information was available from other sources.
  - Whether the information request is particularized.
  - Whether the advice concerns the present litigation.
  - The court noted *Garner's* other "good cause" factors supported disclosure: (i) disclosure would not reveal trade secrets, (ii) the allegations implicate criminal conduct under the Foreign Corrupt Practices Act, and (iii) IBEW is a legitimate shareholder of IBEW.
- Court applied these same *Garner* "good cause" factors to conclude they justified disclosure of attorney "work product."
- Court attempted to protect the produced privilege documents from disclosures to third parties- can this be done as a practical matter?

Illustration of Application of *Garner/Walmart* in Delaware: In re *Lululemon*

- *In re Lululemon Athletica Inc. 220 Litigation*, No. 9039-VCP, 2015 WL 1957196 (Del. Ch. April 30, 2015).
- Plaintiff brought insider trading/*Brophy* claims against the Board Chairman and company founder related to trading that occurred before CEO's resignation was announced.
- Court agreed that emails with the corporation's inside counsel were privileged, but found that the *Garner* exception applied.

Application of *Garner/Walmart* in Delaware: In re *Lululemon* (cont.)

- "Good cause" existed under *Garner* because:
  - (1) the stockholder's mismanagement and insider-trading claims were colorable since the timing and magnitude of the trades was suspicious,
  - (2) the information sought was necessary for the investigation and likely unavailable elsewhere, e.g., email with director went to mismanagement claim and whether there was any investigation, and
  - (3) the legal advice in the emails was more like "real-time" evidence than preparatory plans for litigation.

Application of *Garner/Walmart* in Delaware: *Amalgamated Bank v. Yahoo! Inc.*

- *Amalgamated Bank v. Yahoo! Inc.*, 132 A.3d 752 (Del. Ch. 2016). Case has been treated as *Disney* revisited. Plaintiff sought "counsel documents" under *Garner* and *Wal-Mart*. Court found request premature and unjustified:
  - Plaintiff has not yet shown that these documents are "essential" to pursuing its Section 220 inquiry intro claimed wrongdoing.
  - If counsel documents show up in other board and CEO documents that court found essential, defendants shall identify them on a privilege log and the court can evaluate whether they are essential then.

Application of *Garner/Walmart* in Delaware: *Buttonwood Tree Value Partners v. R.L. Polk*

- *Buttonwood Tree Value Partners v. R.L. Polk*, 2018 WL 346036 (Del. Ch. Jan. 10, 2018). Plaintiffs minority shareholders challenged a self-tender to the Polk family when they sold the company two years later for three times the self-tender price.
- Plaintiffs claimed the Polk family directors breached their fiduciary duties to them and sought legal advice to them related to the self-tender and the subsequent sale of the compan

Application of *Garner/Walmart* in Delaware: *Buttonwood Tree Value Partners v. R.L. Polk*

- Court found *Garner* exception not met:
  - It started by noting that the privilege promotes justice by encouraging candor between clients and their lawyers, and that the *Garner* exception to this should be "narrow, exacting, and . . . difficult to satisfy."
  - It found that plaintiffs had stated a colorable claim, and that the challenged documents were appropriately narrowed and identified.
  - It found that the exception did not apply, however, because the information on the company's sale and the Polk family's plans for this could be available from other sources, such as through depositions.

Application of *Garner/Walmart* in Delaware: *Morris v Spectra Energy Partners*

- *Morris v Spectra Energy Partners*, 2018 WL 2095241 (Del. Ch. May 7, 2018). Plaintiff unitholder in a limited partnership challenged transfer of certain assets of the limited partnership by the general partner to its principal.
- The chancery court held the *Garner* exception could not apply when the limited partnership agreement eliminates all fiduciary duties. Thus, the only duties due in this relationship were contractual.

Application of *Garner/Walmart* in Delaware: Some Concluding Thoughts

- It appears that Delaware courts are reading the *Garner/Walmart* exception narrowly in most instances, but there is a substantial risk of disclosure when advice on high stakes issues are involved, *e.g., Walmart, Lululemon*.
- Because of uncertainty and potential application of *Garner/Walmart*, counsel advising the corporation will need to consider that sometimes their advice effectively may not be privileged and confidential.
- Because of uncertainty and potential broad application of *Garner/Walmart*, corporate officers may need to consider engaging their own counsel to be able to receive candid privileged advice in any fraught situations.

RECENT DEVELOPMENTS IN DELAWARE CASE LAW ON EXECUTIVE COMPENSATION

Calma v Templeton (aka "Citrix"): Director Compensation and Entire Fairness Standard

- *Calma v. Templeton*, 114 A. 3d 563 (Del. Ch. 2015). Breach of fiduciary duty claim relating to director equity awards survives motion to dismiss
- Business judgment rule held inapplicable; instead, subject to review under entire fairness" standard
- Key issue: equity plan was approved by shareholders, but did not include director limits:
  - Shareholder approval of plan with overall limit of 1 million shares (market value of $55 million) was not approval of awards to directors.
  - Entire fairness standard applies since no shareholder ratification.

In re Investors Bancorp Stockholder Litigation: Director Compensation and Requirement of Specific or Self-Executing Awards

- In the underlying case, the board submitted and shareholders approved 2015 Equity Incentive Plan:
  - For non-employee directors had sublimit of 30% of all restricted stock (appx 3.9 million shares) or options (appx. 5.3 million shares) offered in the plan.
  - Average non-employee director comp for peers was around $157,000.
  - After 2015 EIP approved, non-employee directors awarded themselves $2,034,000 each under the plan.
- Chancery Court held these awards were protected by the business judgment rule because the director awards had meaningful limits; Supreme Court rejected that standard and reversed.

In re Investors Bancorp Stockholder Litigation: Director Compensation and Requirement of Specific or Self-Executing Awards

- *In re Investors Bancorp Stockholder Litigation,* 177 A. 3d 1202 (Del. 2017), the Delaware Supreme Court held that ratification (and the protection of the business judgment rule) extends only to specific or self-executing awards:
  - It distinguished between the legal authority to make an award within approved limits, and the exercise of fiduciary discretion to make an award within those limits.
  - Because discretion was being exercised on self-interested acts, the directors had to show these awards were entirely fair to the company.

In re Saba Software Shareholder Litigation: Director Comp Allegedly Tainting Merger Decision

- *In re Saba Software Shareholder Litigation,* 2017 WL 1201108 (Del. Ch. April 11, 2017). Company deregistered for failing to correct financial statements for fraud.
- Company merged in deal that shareholders claimed was too low and forced on them because of deregistering of their stock. Other bidders were appearing during this period.
- Claim board approved deal because it allowed them to turn illiquid equity awards into cash. Court held this was sufficient to allege breach of duty of loyalty.

Feuer v. Redstone: Waste and Incapacitated Executive

- *Feuer v. Redstone*, 2018 WL 1870074 (Del. Ch. April 19, 2018). Shareholder derivative action on behalf of CBS, challenging controlling shareholder and Executive Chairman Sumner Redstone's compensation from May 2014 forward:
  - Redstone's base salary was $1.75 million during this period, and CBS employed him under an employment agreement that could be terminated by either party at will.
  - Beginning in spring 2014, Redstone (who was 91 years old by then) suffered a precipitous decline in health, and had minimal participation in the corporate affairs after this.

Feuer v. Redstone: Waste and Incapacitated Executive

- The court found that plaintiff made out plausible allegations of waste regarding Redstone's salaried compensation from 2014 forward. The court noted:
  - Redstone's employment agreement required him to be actively engaged in performing certain duties for CBS,
  - And that the board had ample notice that Redstone was not meeting this standard from mid-2014 onward.
- The court noted the board did not have to act promptly upon the first sign of Redstone's incapacity, but that here it failed to act for approximately 20 months.
  - This included failing to provide any documentation of internal analysis or discussion candidly assessing Redstone's capability and the pros and cons of terminating his employment.