Pearl Meyer

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Trends in Director Pay Litigation Against Biotech Companies

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Lawsuits related to director pay remain an ongoing concern for biotech companies, given the plaintiff bar's continued focus on compensation and proxy matters. These lawsuits are exceedingly difficult to defeat with a pre-trial motion to dismiss. Instead, companies that allegedly paid excessive director compensation typically settle so that they can avoid the risk, distraction, and expense of discovery and of trial. To better understand how director compensation litigation is impacting our clients in the biotech industry, we reviewed fourteen recent settlement agreements. The following outlines our findings.

What type of biotech companies were sued?

All types of biotech companies are sued for alleged excessive director compensation. In our review, we identified suits involving large (market capitalization above $5 billion) and small (market capitalization below $30 million) companies, pre-commercial and commercial companies, growing companies, and companies that were struggling.

How does this happen?

One of the most common reasons that companies are identified as targets for these lawsuits is the reported value of the equity awards granted to directors. In the study, the equity value represented between approximately 80% and 90% of the total compensation provided to directors for the year immediately prior to the year in which the lawsuit was filed.

The reported values can become significant in the scenario where a board grants directors a fixed number of shares or stock options each year and the stock price since the last grant increased significantly. It is important to note that the reported value is rarely consistent with the value the director ultimately realizes from the grant.

What do the settlements look like?

In our review of the settlement agreements, we observed that the same three or four plaintiffs' firms brought most of the lawsuits. Accordingly, the settlement agreements were all structured similarly, and while each of the settlements was unique to its respective lawsuit, we noted the following in nearly all of the agreements that we reviewed:

1. The directors were not required to disgorge the alleged excessive compensation;
2. The target company was required to either amend its existing non-employee director compensation policy or adopt a new policy that would remain in effect for three to five years;
3. The board was required to adopt more robust controls around peer group development and non-employee director compensation policy review; and
4. The companies had to pay the plaintiffs' legal fees.

Each of the settlement agreements we reviewed claims to enhance the target company's governance practices, strengthen corporate controls, and benefit the company's shareholders.

What we found

Every settlement agreement we examined required the target company to either adopt a new non-employee director compensation policy or amend their existing policy to satisfy various demands made by the plaintiffs. These policies were universally subject to annual limits on the value of cash, equity, or total compensation that each director may receive. The settlements pegged the caps to either a dollar amount or market percentile (e.g., the 50th percentile of the company's peer group).

All but three of the settlement agreements we reviewed required the target company to work with an independent compensation consultant to review the peer groups and the non-employee director compensation policies on an annual basis and to make changes as necessary. About half of these settlements directed the target company to choose peer companies that were similar in terms of industry and size, as defined primarily by market cap, and secondarily by revenue, headcount, and research and development expenses.

About a quarter of the settlement agreements we reviewed included a requirement that the target company adopt stock ownership guidelines requiring directors to hold company stock in an amount equal to either three times or five times the annual cash retainer. Similarly, we noted that about a quarter of the settlement agreements included a requirement that shareholders approve the new or amended non-employee director compensation policies at the next annual shareholder meeting.

Each of the target companies made a cash payment to cover the plaintiffs' attorney fees. These payments ranged from $240,000 to $1.5 million. The median settlement payment was approximately $400,000.

Implications and our recommendations

What can biotech companies do to stay out of the plaintiff bar's crosshairs? Adopting the following best practices should help to insulate most from potential excessive director compensation lawsuits.

- **Establish an appropriate peer group and review director compensation regularly.** The peer group should be comprised of companies that are similarly situated and are selected in a logical fashion. Best practice is to review the peer group annually and update as necessary. Set compensation levels using the peer group with an eye towards providing fair and reasonable director compensation. Boards should be wary of outlier compensation practices that appear more generous than the market, and decisions to include or maintain those features should be carefully considered in the context of potential director compensation litigation.
- **Consider whether a hybrid approach to sizing equity grants is appropriate.** As part of the annual director compensation review, discuss the merit of a hybrid approach to setting director equity grants, either a fixed-share amount with a maximum value cap, or a value-based award amount with a maximum fixed-share cap. Having this hybrid approach creates more complexity in the program but is a significant mitigator of director compensation litigation exposure.
- **Consider enhanced proxy disclosure regarding the process for setting**

compensation. The level of disclosure regarding executive compensation has increased significantly over time, but few companies go into detailed disclosure covering how non-employee director compensation is set. Consider expanding this disclosure as a means to inform shareholders of the process, as well as mitigate the risk of litigation.

- **Review the expected value of the directors' annual equity grants prior to issuance.** Calculate the expected value of the upcoming grants to ensure that the expected reported value of the grant, when combined with the cash compensation provided to directors, does not create excessive compensation values that will be reported in the next annual proxy statement. For companies with annual director compensation limits embedded in their equity incentive plan or director compensation policies, it also provides a helpful check to ensure compensation is within the stated limits.

About the Author

Terry Newth is a managing director at Pearl Meyer. He consults on the design, development, and assessment of executive compensation programs that support each organization's business objectives, long term business strategy, and organizational culture. His clients range from Fortune 500 organizations to pre-IPOs to private and family-owned companies in a wide range of industries. Terry's areas of expertise include pay strategy and philosophy development, market-based pay studies, incentive plan design, severance and CIC arrangements, outside director pay, transaction-related compensation, CD&A and supporting table disclosures, corporate governance, and share plan authorizations.

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