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# Meridian Client Update

## Delaware Case is a Cautionary Tale for Corporate Boards

**Ideally, a corporate board’s decision-making is always based on a robust process and fulsome inquiry. In the absence of a robust process and fulsome inquiry, a corporation may be vulnerable to shareholder requests to review highly sensitive documents. That point was driven home in a recent court decision against Yahoo! Inc. (i.e., *Amalgamated Bank v. Yahoo! Inc.*).**

The Yahoo! case centered on the hiring and firing of Mr. Henrique de Castro, Yahoo!’s second ranking officer. Ms. Marissa Mayer, Yahoo!’s CEO, spearheaded the recruitment of Mr. de Castro, a former colleague of Ms. Mayer at Google, Inc. She also negotiated the terms of Mr. de Castro’s compensation and severance package. In his first year of employment, Mr. de Castro’s compensation package was worth \$39 million, which made him among the top 10 paid executive officers in Silicon Valley according to Court documents. Fourteen months after his hire, Ms. Mayer terminated Mr. de Castro due to performance issues. He received a severance package reportedly worth nearly \$60 million.

During 2014, Amalgamated Bank sought to inspect Yahoo!’s books and records to investigate, among other things, Yahoo!’s payment of allegedly excessive compensation to Mr. de Castro and the circumstances surrounding Mr. de Castro’s departure from the Company. Yahoo! agreed to produce some but not all the requested documents. Amalgamated Bank filed suit in Delaware Chancery Court to compel Yahoo! to produce the withheld documents. ***The Delaware Chancery Court upheld Amalgamated Bank’s demand and ordered Yahoo! to produce documents concerning Mr. de Castro’s compensation and severance package and termination.*** The information obtained from the requested documents may provide Amalgamated Bank with facts sufficient to support a shareholder derivative suit against Yahoo! claiming Yahoo!’s Board and CEO breached their fiduciary duty in Mr. de Castro’s hiring and firing and the development of his compensation and severance package.

### KEY TAKEAWAYS

- The Court did **not** require proof of actual wrongdoing by Yahoo! or its CEO for Amalgamated Bank to establish its right to inspect corporate books and records for the purpose of investigating **possible** wrongdoing by the Board and/or CEO.
- Rather, Amalgamated Bank was only required to show that a “credible basis” exists from which the Court could infer **possible** wrongdoing by Yahoo! and its CEO (the credible basis standard carries the lowest possible burden of proof).
- Amalgamated Bank met the credible basis standard principally through factual allegations that Yahoo! and its CEO failed to properly vet Mr. de Castro’s compensation package and his hiring and firing.
- The Yahoo! case serves as a strong reminder to Compensation Committees to employ sound governance procedures (including ample review and discussion) in decision-making on executive officer employment and on compensation/severance packages and to evidence its decision-making through robust documentation.

## Amalgamated Bank’s Demand to Inspect Books and Records

Under Delaware law, a corporate shareholder has the right to inspect a corporation’s books and records under certain circumstances. If a Delaware corporation denies a shareholder’s demand to inspect its books and records, the shareholder may sue to compel the corporation to produce the requested documents. To prevail, a plaintiff-shareholder must establish, among other things, that it possesses a “proper purpose” for conducting the inspection and that each category of requested books and records is essential to this purpose. As noted above, a shareholder’s request to inspect the books and records of a corporation is often a prelude to a derivative shareholder suit based on information derived from such books and records.

The Court found that Amalgamated Bank’s interest in investigating potential wrongdoing or mismanagement by the Yahoo! Board of Directors and its CEO was a proper purpose to obtain the demanded books and records of Yahoo!. In this regard, the Court noted that Amalgamated Bank need **not** prove that wrongdoing or mismanagement actually occurred. Rather, Amalgamated Bank need only demonstrate a “credible basis” from which the Court could infer there was **possible** mismanagement that would warrant further investigation.

**As discussed in detail below, the Court found that Amalgamated Bank established a credible basis to suspect wrongdoing in connection with Mr. de Castro’s hiring and firing that would warrant further investigation.**

## The Court Finds Possible Wrongdoing by Yahoo! Board and Yahoo!’s CEO

The Court found that Amalgamated Bank met the “credible basis” standard by demonstrating (i) possible breach of fiduciary duty in the hiring process of Mr. de Castro by Yahoo!’s CEO and the Yahoo! directors, (ii) possible breach of fiduciary duty in the firing process of Mr. de Castro by Yahoo!’s CEO and the Yahoo! directors and (iii) possible corporate waste.

- **Possible Breach of Fiduciary Duty in the Hiring Process of Mr. de Castro by Yahoo!’s CEO and Yahoo! Directors.** The Court found that the factual allegations provide a credible basis to suspect that Yahoo!’s CEO and the Yahoo! Board of Directors breached their fiduciary duty in the hiring process of Mr. de Castro in the following respects:
  - Yahoo’s CEO failed to provide material information to the Yahoo! Compensation Committee during the early stages of the hiring process, when she withheld Mr. de Castro’s name, position, and qualifications while seeking the Yahoo! Compensation Committee’s blessing for a large compensation package that the Committee’s compensation consultant regarded as generally greater than the market data supported.
  - Yahoo!’s CEO provided inaccurate information to the Yahoo! Compensation Committee about the terms of Mr. de Castro’s original offer letter when asking the Committee to approve a change to Mr. de Castro’s compensation package, and the Committee agreed to the change based on the inaccurate information that Ms. Mayer provided to it. These changes substantially increased the payout on certain equity awards granted to Mr. de Castro.
  - In preparing the final offer letter, Yahoo!’s CEO made additional changes to the terms of Mr. de Castro’s employment that materially increased his potential severance compensation. Ms. Mayer apparently did not inform the Yahoo! Compensation Committee about the changes, and the Committee apparently did not authorize the changes to Mr. de Castro’s compensation package.

— Yahoo!'s Board of Directors' involvement in the hiring of Mr. de Castro appears to have been tangential and episodic, and the Board seemed to have accepted Ms. Mayer's statements about Mr. de Castro uncritically. The Court noted that a board cannot "mindlessly swallow" information provided by senior management, particularly in the area of executive compensation, but rather a board must exercise its own business judgment in approving executive compensation.

■ **Possible Breach of Fiduciary Duty in the Firing Process by Yahoo!'s CEO and Yahoo! Directors.**

The Court found that the factual allegations provide a credible basis to suspect that Yahoo!'s CEO and the Yahoo! Board of Directors breached their fiduciary duty in the firing process of Mr. de Castro in the following respects:

- Yahoo!'s CEO decided to characterize Mr. de Castro's termination as without "cause" when a termination for cause alternative was potentially available.
- The Yahoo! Compensation Committee did not question Ms. Mayer's characterization of Mr. de Castro's termination.
- The Yahoo! Compensation Committee did not appear to have conducted any inquiry into the termination of Mr. de Castro but instead approved his termination by Ms. Mayer through a quick email exchange of written consents. Nonetheless, Mr. de Castro received severance benefits worth nearly \$60 million (which includes the value of equity awards that vested upon his termination).
- The Yahoo! Compensation Committee did not receive a report about the reasons for Mr. de Castro's termination until several weeks after his termination, when they decided not to award him a bonus under the Executive Incentive Plan.

■ **Possible Corporate Waste.** Corporate waste occurs when a corporation effects a transaction on terms that "no person of ordinary, sound business judgment could conclude represent a fair exchange." The Court noted that the test to find corporate waste presents an extremely high standard that is "rarely" satisfied by a shareholder-plaintiff. Nonetheless, the Court found that the factual allegations by Amalgamated Bank demonstrated a credible basis to suspect "corporate waste" in the following respects:

- Ms. Mayer's unilateral increase in Mr. de Castro's potential severance compensation under his final offer letter, without the approval of the Yahoo! Compensation Committee or Board.
- Mr. de Castro potentially could have been fired for cause, thereby avoiding the payment of nearly \$60 million in severance benefits.

## Avoiding a Yahoo! Situation

Typically, the hiring and firing of a senior executive is a complex process involving multiple parties. To avoid the traps that Yahoo! fell into with respect to Mr. de Castro, we recommend that Compensation Committees (Committee) maintain the following process for hiring and firing of an executive officer:

■ **General Process around Hiring and Firing of an Executive Officer**

- *Ask direct and thorough questions and spend required time.* The most significant criticisms leveled by the Court in the Yahoo! case is that the Yahoo! Compensation Committee appeared uninvolved throughout the hiring and firing of Mr. de Castro and failed to spend the time necessary to fully understand the circumstances of his hiring and firing. To avoid this criticism, a Committee must be

actively involved in the hiring and firing process and spend the time necessary to gain a complete understanding of the circumstances around the hiring or firing of an officer. This includes asking direct and thorough questions of management to justify the hire of a new officer (including other potential candidates) and the officer's proposed compensation (including sign-on and buy-out awards) and severance package (or the termination of an incumbent officer and the officer's potential severance payout).

- Document decision-making process. All aspects of the Committee's decision-making as to the hiring and firing of an executive officer should be fully documented in Committee minutes, including (i) identification of all attendees, (ii) relevant comments and questions by Committee members, management and outside advisers, (iii) reference to documents and presentations submitted to the Committee for review and/or approval, including a review of appropriate competitive market data, and (iv) open issues and the parties responsible for their resolution.
- Consult with compensation and legal advisers. The Committee should obtain advice from its compensation consultant and external legal counsel as to the appropriateness of any proposed compensation and severance package for a proposed candidate. Similarly, the Committee should obtain advice from these advisers as to the determination and appropriateness of any severance benefits payable a terminated officer.

## ■ Hiring Process

- Require full and independent vetting of candidate. The Committee should ensure that any proposed candidate has been fully and independently vetted. This is particularly important when a candidate had a prior working relationship with a company's CEO (as was the case in Yahoo!). For example, the Committee could direct the company's general counsel to undertake a thorough review of any candidate, including a comprehensive background check, reviewing accuracy of resume, interviewing references and, to the extent possible, assessing performance at current and prior employers.
- Interview candidate. For senior officer hires, the Committee Chair or Board Chair (or lead director if the CEO is the Board Chair) should conduct a comprehensive interview of a candidate to gain a more complete understanding of the candidate's background, working philosophy and fit with the organization. The interview process should be conducted without the presence of the CEO or any other officer of the company.
- Review qualitative summary of and rationale for proposed compensation and severance package. Management should provide to the Committee a comprehensive summary of the key terms of a proposed compensation and severance package (and any material changes during the course of negotiations), including details on (i) the mechanics of each variable pay program (e.g., performance period, performance goals, payout matrix), (ii) any sign-on bonus or guaranteed bonus, including how such bonus was sized and the rationale for paying the bonus, (iii) all equity incentive grants, including sign-on and buy-out awards and the terms and conditions of such awards, (iv) the types of severance benefits (e.g., cash severance, vesting acceleration of equity awards), (v) payment triggers, (vi) the potential severance payments under various triggering events and (vii) any applicable restrictive covenants. Management should also provide to the Committee a comparative analysis of the candidate's and similarly ranked incumbent executives' compensation and severance package, which analysis should highlight material differences and the rationale for such differences.

- Review quantitative analysis of compensation package. Management should provide to the Committee a comprehensive analysis of proposed compensation package, which analysis should show (i) the value of each component of compensation, (ii) for variable components of compensation, range of potential payouts, (iii) the value of any guaranteed bonus, (iv) the value of any sign-on bonus, (v) the value of all equity incentive awards, (vi) the value of each perquisite and (vii) the value of executive retirement benefits. These values should also be developed across various potential scenarios (e.g., potential pay levels over three to five year period, equity values based on various share prices).
- Review quantitative analysis of severance package. Management should provide to the Committee a comprehensive analysis of any proposed severance package, which analysis should show the value of each severance benefit (i.e., cash severance, accelerated vesting of equity awards, etc.) across various potential scenarios (e.g., different types of employment termination, various share prices). A separate analysis should be prepared for general severance outside of a change in control and change in control related severance.

■ **Firing Process**

- Review performance evaluation. Management should provide to the Committee a comprehensive performance evaluation of the subject officer whose employment the CEO is proposing to terminate.
- Determine proper characterization of termination. The Committee should independently determine whether the proposed termination is properly characterized as without or with “cause.”
- Interview chief HR and legal officers. The Committee should interview the company’s chief HR and legal officers to obtain their input and views on the proposed termination of an officer.
- Confirm effectiveness of any applicable release and restrictive covenants. The Committee should obtain advice from internal and/or external legal counsel as to the effectiveness of any applicable restrictive covenants and release and waiver of claims under the circumstances of the proposed termination of an officer.
- Review severance package. Management should provide to the Committee a comprehensive analysis of the severance benefits the officer would be entitled to upon termination of employment, under both a cause and without cause termination.

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