# Director Compensation in 2019

A recent decision of the Delaware Court of Chancery (*Stein v. Blankfein, et. al.*) is a stark reminder of the ongoing risk of litigation over director compensation. Reaffirming the decision of the Delaware Supreme Court in *In re: Investors Bancorp, Inc. Stockholder Litigation*, the Chancery Court refused to dismiss a breach of fiduciary duty claim predicated on allegations that discretionary cash and equity compensation the non-employee directors of The Goldman Sachs Group awarded themselves was excessive. In reaching this decision, the Court applied the more rigorous "entire fairness" standard, rather than the more deferential "business judgment" rule.

This Thoughtful Pay Alert summarizes recent Delaware case law on director compensation, as well as steps that boards of directors can take to reduce the risk of becoming a target for a director compensation lawsuit.

## Background

### "Business Judgment" Rule vs. "Entire Fairness" Standard

Under Delaware law, decisions by a board of directors are generally protected from second-guessing by the "business judgment" rule. Under this standard of review, a stockholder questioning a board decision assumes the burden of establishing that directors, in reaching their challenged decision, breached their fiduciary duties of good faith, loyalty, and/or due care. However, where the directors have an interest in the transaction in question, such as when setting their own compensation, the burden shifts to them to prove that the transaction, including the process used and the amount involved, is objectively fair to the company and its stockholders (the "entire fairness" standard).

### Investors Bancorp

In December 2017, in *In re: Investors Bancorp, Inc. Stockholder Litigation*, the Delaware Supreme Court found that a discretionary decision by directors about their own compensation involved an inherent conflict of interest, even though the plan pursuant to which the awards were made both was approved by stockholders and contained an aggregate limit on the maximum number of shares that could be granted to directors. As a result, the Supreme Court applied the "entire fairness" standard. As set forth in the *Investors Bancorp* decision, the "business judgment" rule is available only if (i) the specific awards being granted are approved by fully disinterested stockholders or (ii) are granted pursuant to a stockholder-approved, "self-executing" formula-based plan. See our Thoughtful Pay Alert, [Director Compensation Decision-Making Process Back in the Spotlight] (January 10, 2018).

### The Stein v. Blankfein Decision

Many observers were skeptical about the extent to which *Investors Bancorp* would impact future claims of "excessive" director compensation, given the extreme facts of that case, However, on May 31, 2019, the Chancery Court reaffirmed the primacy of the "entire fairness" standard when reviewing the decisions of the directors at The Goldman Sachs Group involving their own compensation. In essence, the Chancery Court applied the "entire fairness" standard under significantly less egregious facts than were present in *Investors Bancorp*. (See below for a detailed summary of the *Stein v. Blankfein* decision.)

## Minimizing the Risk of Litigation

The decision in *Stein v. Blankfein* is a clear setback for companies hoping to insulate themselves from claims of "excessive" director compensation solely by adopting a formal limit on the amount that directors can pay themselves. Following *Stein v. Blankfein*, it would appear that whenever directors are determining their own compensation, Delaware courts are likely to apply the "entire fairness" standard where there are allegations of "excessive" compensation or breach of fiduciary duty.

Currently, the surest way to minimize the litigation risk is to seek stockholder approval of each individual director award or grant awards pursuant to a stockholder-approved, "self-executing" formula-based plan.

We recognize that such an approach may not be preferred by many companies, which may necessitate other action to help safeguard your director compensation program. Accordingly, in the current environment, we recommend that boards of directors consider taking the following steps when setting or reviewing their director pay arrangements. These will help reduce the risk of a lawsuit or, if a lawsuit is brought, support the company in its efforts to satisfy the "entire fairness" standard:

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- **establish a formal process for periodically reviewing the director compensation program** that will enable the company to demonstrate that its compensation levels are fair and reasonable. At a minimum, this will include:
    - **engaging a compensation consultant to facilitate the review process** every year (or every other year if compensation is adjusted less frequently than annually);
    - **selecting a group of reasonable peer companies** to define the competitive market and targeting appropriate pay positioning for cash and equity compensation; and
    - **assessing your current board composition and workload**, considering factors such as the number of directors serving on the board and each board committee, board size relative to peers, and the expected time commitment (for example, board and committee meeting frequencies) from each director relative to peers;
- **ensure that the compensation plan used for making director awards contains a stockholder-approved annual limit on compensation** payable to directors which operates as a meaningful restriction on director discretion (that is, the limit should be based, in part, on your analysis of competitive market data); and
- **enhance the proxy statement disclosure of the director compensation program** to ensure that it includes a fulsome description of the pay-setting process and, where appropriate, the basis for any changes to existing compensation amounts.

While there can be no assurance that a company won't be subject to a claim of "excessive" director compensation based on its specific situation, we believe that these actions will help reduce a company's attractiveness as a target for such a claim. Further, should such an action be brought, we believe that the foregoing steps should help establish an effective rebuttal to any allegations of an unfair process or quantum of pay.■

## *The Stein v. Blankfein Decision – A Summary*

In *Stein v. Blankfein*, a stockholder-plaintiff sued the non-employee directors of The Goldman Sachs Group alleging that, among other things, the directors had breached their fiduciary duty of loyalty by paying themselves cash and equity compensation which, in the aggregate, was excessive when compared to that paid by their U.S. peers. Specifically, the plaintiff alleged that, in the pertinent years:

- Each non-employee director received approximately $600,000 in annual compensation;
- Such compensation was substantially more than the non-employee directors of the four U.S. peer companies that Goldman Sachs identified in its proxy statements for the same time period (the average compensation of these peer companies was approximately $350,000); and
- Goldman Sachs had less net revenue and net income than each of the peer companies in one of the years in issue and less net revenue and net income than three of the peer companies in another one of the years in issue.

Since the directors set their own compensation, the plaintiff asserted that these decisions were subject to review under the "entire fairness" standard.

In response, the director-defendants moved to dismiss this claim on two grounds: (i) their equity awards were granted pursuant to the company's stock incentive plans, which contained a provision calling for the waiver of the "entire fairness" standard; and (ii) the plaintiff failed to adequately plead that the compensation paid were not entirely fair. With respect to this latter argument, the defendants also pointed out that the plaintiff had not raised any objections to the compensation process and that an external compensation consultant had advised with respect to the compensation decisions.

At the outset, the Chancery Court rejected the defendants' waiver argument, noting that the waiver language was not sufficient for the stockholder approval of the plan to constitute a knowing and informed waiver of their rights when it came to directors' interested transactions under the plan.

More importantly, the Chancery Court also rejected the defendants' argument that the allegations that the compensation was unfair were inadequate. Assuming that the allegations were true for purposes of evaluating the motion to dismiss, the Chancery Court noted that the plaintiff had alleged that the company's stock incentive plans set no specific limit on non-employee director compensation and permitted directors to use their discretion to set such compensation, the non-employee directors' compensation was almost two times the average of that of the directors at the self-selected peer companies, the peer company directors attended more meetings than the defendant directors, and the peer companies had similar or better performance than Goldman Sachs during the years at issue. The Chancery Court found these allegations to meet the low threshold for pleading the existence of some facts suggesting unfairness. In its view, this was sufficient to survive a motion to dismiss.

Consequently, the lawsuit will now proceed to discovery and, if not otherwise disposed of, a factual review of the fairness of the compensation-setting process and the amounts paid.

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