Director Compensation Decision-Making Process Back in the Spotlight

A recent decision of the Delaware Supreme Court (*In re: Investors Bancorp, Inc. Stockholder Litigation*) has renewed questions about when decisions by a board of directors concerning its own compensation will be protected by the "business judgment" rule. Weighing in for the first time in over 50 years on the appropriate legal standard to be used where stockholders have approved an aggregate limit on director compensation (instead of specific compensation amounts), the Supreme Court narrowed the legal standard that has been developed in recent years in response to numerous director pay lawsuits. While many observers believed that prior guidance from the Delaware courts had established a clear course for minimizing the risk of successful "excessive" pay claims when directors set their own pay, the Supreme Court's decision serves as a reminder that companies must act carefully in designing their director compensation arrangements.

Three Things That Technology and Life Sciences Companies Should Know about the Investors Bancorp Decision

1. **The Underlying Facts** – The directors of Investors Bancorp adopted an equity incentive plan for employees and non-employee directors that contained an aggregate limit of 30% of all shares under the plan that could be granted in any calendar year to non-employee directors. Following stockholder approval of the plan, the directors immediately granted themselves equity awards with an aggregate grant date value of $51.5 million.

2. **The Supreme Court's Decision** – Reversing the decision of the lower court, the Supreme Court held that the business judgment rule does not apply to director equity awards granted pursuant to a plan that permits directors discretion in making such awards. Instead, the directors' actions are subject to review under the much stricter "entire fairness" standard which requires the directors to show that the award process and amounts are objectively fair. The business judgment rule is available if (i) the specific awards are approved by fully disinterested stockholders or (ii) are granted pursuant to a non-discretionary, "self-executing" stockholder-approved plan.

3. **The Decision's Potential Impact** – Companies seeking certain protection under the business judgment rule may choose to return to "formula" plans for their director equity awards and/or obtain stockholder approval of specific individual awards. For many companies, providing a "meaningful limit" on director equity awards (presumably an individual per year limit set at a competitively reasonable level) in their equity incentive plan and clear disclosure of the process used to design this limit and set director pay (for example, use of a consultant and a formal analysis of relevant competitive market practices) should help minimize litigation risk.

© 2017 Compensia, Inc. All rights reserved.

Background – Director Compensation and the Applicable Judicial Review Standard

Under Delaware law, decisions by a board of directors are generally protected from second-guessing by the business judgment rule. Under this rule, 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. Where the directors have an interest in the transaction in question, however, 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 entirely fair to the company and its stockholders (the so-called "entire fairness" standard).

In recent years, several lawsuits have alleged breach of fiduciary duty involving "excessive" director pay. Invariably, the success of these lawsuits has turned on which party prevailed in response to the company's motion to dismiss the suit. Typically, where the directors have not received the protection of the business judgment rule and, instead, have been required to show the entire fairness of their pay decisions the suit has survived the motion to dismiss. In most cases, this has prompted the company to settle the suit before it reached the discovery phase.

Consequently, ensuring the protection of the business judgment rule when setting director compensation has become a priority. Based on earlier Delaware court decisions, companies have sought to avail their directors of this protection using a stockholder-approved employee stock plan containing "meaningful limits" on directors' discretion to grant themselves equity awards and, thus, minimize their exposure to "excessive pay" lawsuits.[1] Although based on a particularly unfavorable set of facts, *Investors Bancorp* may change how some companies choose to approach this issue.

The Investors Bancorp Lawsuit

The essential facts that triggered the original stockholder lawsuit are straightforward:

- In March 2015, the Board of Directors of Investors Bancorp approved an equity incentive plan from which equity awards could be granted to officers, employees, non-employee directors, and other service providers.
- Among the plan terms were various limits on the number of shares that could be granted pursuant to various equity vehicles, as well as on the number of shares that could be granted to various plan participants (either individually or in the aggregate).
- Specifically, the plan provided that the maximum number of shares that could be granted to all non-employee directors, in the aggregate, pursuant to the exercise of stock options or the grant of restricted stock or restricted stock unit awards was to be 30% of all options or restricted shares available for awards, "All of which may be granted in any calendar year." It appears that the plan contained no other limit on director equity awards.
- In connection with the company's Annual Meeting of Stockholders, shareholders received a proxy statement indicating that "[t]he number, types and terms of awards to be made pursuant to the [plan] are subject to the discretion of the [Compensation and Benefits] Committee and have not been determined at this time, and will not be determined until subsequent to stockholder approval."
- Subsequently, in June 2015 the stockholders of the company approved the plan.
- Thereafter, the Board of Directors, upon the recommendation of its Compensation and Benefits Committee, approved the grant of stock options and restricted stock awards to all directors. The total value of the non-employee director equity awards was $21,594,000, or an average of $2,159,400 per director. When employee-director equity awards were factored in, the total value of all awards was approximately $51,654,000.

Following disclosure of the awards, stockholders sued in the Delaware Court of Chancery alleging breach of fiduciary duty by the directors for awarding themselves excessive compensation. Earlier this year, the Chancery Court granted the company's motion to dismiss the lawsuit, relying on its earlier decisions, because, in its view, the plan contained "meaningful, specific limits on awards to all director beneficiaries" and the awards under review were within these limits. Therefore, the approval of the plan by stockholders served to "ratify" the specific equity awards to the directors and, in the view of the Chancery Court, was sufficient to invoke the business judgment rule.

[1] For a discussion of these director compensation lawsuits and ways to minimize the risk of such litigation, see our Thoughtful Pay Alerts, *Director Compensation Litigation – A Mid-Year Update* (July 6, 2016) and *Protecting Your Director Compensation Decisions from Claims of "Excessive Pay"* (May 15, 2015).

© 2017 Compensia, Inc. All rights reserved.

Thereafter, the stockholders appealed the decision of the Chancery Court to the Delaware Supreme Court.

The Delaware Supreme Court Decision

In December 2017, the Delaware Supreme Court reversed the decision of the Chancery Court. In reaching its decision, the Supreme Court noted at the outset that, under Delaware law, because a board of directors' determination of its own compensation is a self-interested transaction it does not receive the presumptive protection of the business judgment rule. Instead, the receipt of the compensation is subject to an affirmative showing that the arrangements are fair to the company – that is, the entire fairness standard of review applies.

While the Supreme Court acknowledged that the board's pay decisions may be subsequently ratified by the approval of a majority of its fully-informed and disinterested stockholders (which would then shift the burden of proof to the objecting stockholders), it focused closely on the evolution of the "ratification defense" where the stockholder-approved plan sets upper limits on the amounts that directors can award to themselves. After reviewing the series of Chancery Court decisions over the past 20 years that have addressed this matter, the Supreme Court identified three situations where the ratification defense has been recognized:

- when stockholders approved the specific director awards;
- when the applicable employee stock plan was self-executing (that is, the plan sets forth the specific awards to be made and the directors have no discretion when making awards); and
- when directors exercised discretion and determined the amount and terms of the awards following stockholder approval.

Stating that the first two situations "present no real problems," the Supreme Court then turned its attention to the third scenario – when directors retain discretion to make awards under the general parameters of the equity incentive plan. After examining the rationale underlying the prior Chancery Court decisions that permitted reliance on the business judgment rule, it effectively dispensed with the "meaningful limits" test and held that when it comes to the exercise of discretion by directors following stockholder approval of an equity incentive plan, the ratification defense cannot be used to foreclose a review of those subsequent discretionary decisions when a breach of fiduciary duty claim has been properly alleged. In this instance, the directors must demonstrate that their self-interested actions are entirely fair to the company.

The Supreme Court then remanded the case back to the Chancery Court for further proceedings consistent with its decision.

Observations

Although the decision of the Supreme Court in this case finds that simply including a limit on the maximum number of shares that directors may grant to themselves as part of a stockholder-approved plan will not be sufficient to claim the protection of the business judgment rule, it doesn't necessarily mean that the companies must now revert to either having stockholders approve each individual director equity award or using a formula-based plan to avoid litigation risk.

While it is now clear that securing stockholder approval of individual director equity awards or a self-executing director compensation plan will ensure the protection of the business judgment rule, there are potential drawbacks to these approaches. For example, requiring stockholder approval or using a formula plan will inevitably limit the flexibility of the board in adjusting director pay as needed. Including meaningful, annual award limits in the stockholder-approved equity incentive plan that are based on market competitive practices may still be a viable approach to setting director compensation.

However, in light of the *Investors Bancorp* decision, boards of directors should evaluate their current processes for reviewing and changing their own compensation arrangements to ensure that they can demonstrate the fairness of their director compensation decisions. At a minimum, this should involve conducting a competitive market analysis of the director compensation program on a periodic basis to confirm that director compensation, including equity awards, is reasonable. Other factors cited by the Supreme Court that are likely to be relevant to a review of the fairness of director pay decisions include:

- whether the awards were made pursuant to a stockholder-approved plan;
- the absolute size of the subject awards;
- the size of the awards relative to the company's historical practices;
- the size of the awards relative to peer company practices;
- the timing and stated purpose of the awards;
- whether the stockholder-approved plan contains appropriate limits and/or guidelines for determining awards which serve as a restriction on director discretion;

© 2017 Compensia, Inc. All rights reserved.

- whether the board of directors (or applicable board committee) was advised by an external compensation consultant; and
- the adequacy of the disclosure about director compensation (both when stockholder approval of the applicable plan is sought and thereafter in the company's proxy statement), including the process used to set compensation levels.

As the Supreme Court noted, to prevail against a motion to dismiss, a stockholder must allege facts that support an inference that directors may have breached their fiduciary duty when granting themselves equity awards. We believe that the foregoing factors may help establish an effective rebuttal to any such allegations. Thus, even under the entire fairness standard of review, companies should be able to minimize their potential litigation risk while continuing to compensate their directors at reasonable and appropriate levels.

Need Assistance?

Compensia has extensive experience in helping companies design and implement compensation programs for the members of the board of directors. If you would like assistance in developing or reviewing your director pay practices, or if you have any questions on the subjects addressed in this Thoughtful Pay Alert, please feel free to contact Mark A. Borges.■

© 2017 Compensia, Inc. All rights reserved.

About Compensia

Compensia, Inc. is a management consulting firm that provides executive compensation advisory services to Compensation Committees and senior management.

Silicon Valley

125 S. Market Street
Suite 1000
San Jose, California 95113
408.876.4025

Timothy Sparks, Chairman & President
tsparks@compensia.com
408.876.4024

Thomas G. Brown
tbrown@compensia.com
408.876.4023

Susan Gellen
sgellen@compensia.com
408.907.4302

Tom LaWer
tlawer@compensia.com
408.907.4309

Greg Loehmann
gloehmann@compensia.com
408.907.4319

San Francisco

One Embarcadero Center
Suite 2830
San Francisco, California 94111
415.462.2990

Mark H. Edwards
medwards@compensia.com
415.462.2985

Mark A. Borges
mborges@compensia.com
415.462.2995

Erik Beucler
ebeucler@compensia.com
408.907.4314

Amanda Feyerabend
afeyerabend@compensia.com
415.462.2988

Southern California

Ralph Barry
rbarry@compensia.com
858.603.2288

Pacific Northwest

Jason Borrevik
jborrevik@compensia.com
408.876.4035

© 2017 Compensia, Inc. All rights reserved.